SYLLABUS

Unit: I Modern approaches to Demand for Money

Milton-Friedman's Portfolio balance Approach, Approaches of Baumol and James Tobin's wealth adjustment process of Karl Brunner and Allan Melterzer, review of quantity theory and Monetarism-views of Monetarists and Non-Monetarists.

Unit: II Supply of Money

Determinants of money supply-RBI and commercial Banks role in money supply-Exogenous and Endogenous controls of money supply, Money Multiplier, money in a Socialist economy and need for control.

Unit: III Inflation and Deflation

The Mechanism of inflation and its characteristics, Keynesian approach of Inflation-the concept of Inflationary gap, Structural theory of Inflation, Philips curve analysis, Tobin's modified curve, Types and controls of inflation, deflation-causes and consequences.

Unit: IV Financial Institutions and Financial Markets

The structure of the financial system and function of the financial sector-Indian financial system, the role of Banks, Indicators of financial development and Non-bank financial intermediaries- Life Insurance Corporation, HDFC, Housing Finance and structure of money markets, capital markets, SEBI-its performance and appraisal of work.

Unit: V International Financial Institution

International liquidity-IMF and international liquidity-The World Bank, International Development Association -IDA's Resources-India and IDA, Eurocurrency Market-features and its recent development Asian Development Bank (ADB) and its Functions, sources of funds, working of IFC.

Lesson-1

THE NATURE AND FUNCTIONS OF MONEY

Objectives:

After going through this lesson, you should be able to understand the concept, nature of monetary economics which will give a comprehensive understanding of monetary economics.

Introduction

Monetary economics has both a microeconomics component and a macroeconomics one. The fundamental questions of monetary microeconomics concern the proper definition of money and its demand and supply, and those of monetary macroeconomics concern the formulation of monetary policy and its impact on the economy.

The financial assets that can serve the medium of the payments role of money have changed over time, as has the elasticity of substitution among monetary assets, so that the proper definition of money has also kept changing. For short-run analysis, monetary economics is a central part of macroeconomics. The main paradigms of macroeconomics are the classical and Keynesian ones. The former paradigm studies the competitive economy at its full employment equilibrium, while the latter focuses on its deviations away from this equilibrium.

Monetary economics is a branch of economics that provides a framework for analyzing money in its functions as a medium of exchange, store of value, and unit of account. It considers how money, for example fiat currency, can gain acceptance purely because of its convenience as a public good. It examines the effects of monetary systems, including regulation of money and associated financial institutions and international aspects.

Monetary economics is the economics of the money supply, prices and interest rates, and their repercussions on the economy. It focuses on the monetary and other financial markets, the determination of the interest rate, the extent to which these influence the behavior of the economic units and the implications of that influence in the macroeconomic context. It also studies the formulation of monetary policy, usually by the central bank or "the monetary authority," with respect to the supply of money and manipulation of interest rates, in terms both of what is actually done and what would be optimal.

In a monetary economy, virtually all exchanges of commodities among distinct economic agents are against money, rather than against labor, commodities or bonds, and virtually all loans are made in money and not in commodities, so that almost all market transactions in a modern monetary economy involve money. Therefore, few aspects of a

monetary economy are totally divorced from the role of money and the efficiency of its provision and usage, and the scope of monetary economics is a very wide one.

Monetary economics has both a microeconomics and a macroeconomics part. In addition, the formulation of monetary policy and central bank behavior – or that of "the monetary authority," often a euphemism for the central banking system of the country is an extremely important topic which can be treated as a distinct one in its own right, or covered under the microeconomics or macroeconomics presentation of monetary economics.

Microeconomics part of Monetary Economics

The microeconomics part of monetary economics focuses on the study of the demand and supply of money and their equilibrium. No study of monetary economics can be even minimally adequate without a study of the behavior of those financial institutions whose behavior determines the money stock and its close substitutes, as well as determining the interest rates in the economy. The institutions supplying the main components of the money stock are the central bank and the commercial banks. The commercial banks are themselves part of the wider system of financial intermediaries, which determine the supply of some of the components of money as well as the substitutes for money, also known as near-monies.

Macroeconomics part of Monetary Economics:

Money in the macro-economy The macroeconomics part of monetary economics is closely integrated into the standard short run macroeconomic theory. The reason for such closeness is that monetary phenomena are pervasive in their influence on virtually all the major macroeconomic variables in the short run. Among variables influenced by the shifts in the supply and demand for money are national output and employment, the rate of unemployment, exports and imports, exchange rates and the balance of payments. And among the most important questions in macroeconomic analysis are whether – to what extent and how – the changes in the money supply, prices and inflation, and interest rates affect the above variables, especially national output and employment.

What is Money?

Money plays a huge role in the economy; get better grades essential part of every financial system. Money is a means of payment for goods and services, a means of measuring value, as well as a store of value. Generally, to investigate the origin of money, its functions and its role in the economy we need to explore the development of trade exchange, which is the emergence of a stage of development of human civilization. If it were not for money, the exchange will be impossible, so specialization (division of labor) will be. The whole structure of modern economies is predetermined by existence of money. Money appeared due to trade

and as the trade is one of the oldest occupations of mankind, and then the ancient roots of monetary system also throw back to ancient times, though the structure of money greatly varies through centuries.

Demand for money is a prominent issue in macroeconomics due to the important role that monetary demand plays in the determination of the price level, interest income. But, first we should know the meaning of demand for money. In general peoples demand for money is for in order to make payments for their day-to-day purchases of goods &services. Further, demand for money arises from two important functions of money. The first is that money acts as a medium of exchange and the second is a store of value. Thus, individuals and businessman wish to hold money partly in cash and partly in the form of assets. Theoretically, speaks, various schools of thought in economics define differently the demand for money. In fact, people's demand for money is not for nominal money holdings but real money balances, because if people are merely concerned with nominal money holdings irrespective of the price level, they said to suffer from money illusion

In the theory, till recently, there were three approaches to demand for money, namely, transactions approach or Fisher's Quantity theory; Cash Balances Approach or Cambridge equation and, Keynes theory of liquidity preference. However, in recent years Baumol, Tobin and Friedman have put forward new theories of demand for money.

DEFINITIONS AND APPROACHES OF MONEY

Definitions

Anything, which is generally acceptable in payment of debt and is commonly used as a medium of payment or as a standard of value, can be regarded as money. E.R.A. Seligman defines money as "a thing that possesses general acceptability". Walker says, "Money is what money does ". Scarcity is not the general feature but also general acceptability. D.H. Robertson defines money as "anything which is widely accepted in payment for goods or in discharge of other kinds of business obligations".

Approaches:

1. **Conventional Approach**
2. **Chicago Approach**
3. **Gurley and Shaw Approach**
4. **Central Bank Approach**
5. **Reserve Bank Approach**

1. Conventional Approach

The conventional Approach is to define money as currency plus demand deposits in commercial banks.

2. Chicago Approach

According to Chicago Approach, money is a temporary abode of purchasing power which comprises currency plus total commercial bank deposits.

3. Gurley and Shaw Approach

J.G. Gurley and E.S. Shaw, in a series of contributions culminating in a major theoretical work "money in a Theory of Finance (1960) have held that money should include the liabilities of non-banking financial intermediaries as well, because they also constitute liquid answers closely substitutable for money. Gurley and Shaw Gurley and Shaw Approach include in the list of close substitutes for the means of payment the deposits of and the claims against all types of financial intermediaries. Of which commercial banks are only one variety. Gurley and Shaw draw the distinction between inside money and outside money. Outside money comes from outside the private sector and or presents wealth to which there corresponds no debt. It is an asset for someone without being a debt for anyone else. Gold coins and currency notes may thus, be considered as outside money. Inside money, on the other hand, created by financial intermediaries, the assets on the other side of the balance sheet.

4. Central Bank Approach

According to this approach, it includes a means of financing purchases, in much broader concept, measurable or un-measurable, the total amount of credit outstanding, the liquidity of economy, and credit which can be substituted for money without limit.

According to the RadCliffe committee, "money is the whole structure of liquidity that is relevant to spending decisions".

5. Reserve Bank Approach

According to RBI, Monetary Aggregate includes the following:

M1 – currency notes and coins with the public; demand deposits of all commercial and co-operative banks; other deposits held with the RBI.

M2 – M1 + Savings deposits with post office savings banks.

M3 – M1 + Time deposits of all commercial and co-operative banks.

M4 –M3 + Total deposits with post offices.

KINDS OF MONEY

Money can be classified on the basis of its physical form, legal recognition its nature.

1. **Metallic coins, paper money and deposit money**

Metallic coins and paper money are commonly grouped together and designated as "currency", or by the descriptive titles such as 'cash', 'hand to hand money', or 'pocket book money'. Deposit money is issued by commercial banks on the basis of their demand liabilities or deposits or deposits which are transferable by cheques.

1. **'Standard or full bodied coins' and 'token coins'**

A standard coin is that coin whose face value is equal (or almost equal) to its intrinsic value, i.e., the value of its component material. The standard coin is unlimited legal tender and it has generally a free coinage. Examples are gold coin and silver coin.

A token coin, on the other hand, is that whose face material value is appreciably greater than that of the matter of which it is composed. All coins in domestic circulation in the modern economies are token coins, though some of these may be circulating as unlimited legal-tender. Coins of smaller denominations are used as subsidiary money is generally limited legal tender.

2. **Limited legal tender and unlimited legal tender**

Legal tender is that money officially designated by the government as an adequate instrument for the discharge of obligations stated to be payable in domestic currency. Depending upon the degree, legal tender money is further classified as limited legal tender and unlimited legal tender. Subsidiary coins of smaller denominations are legal tender for only limited amounts. Standard coins and currency notes of varying denominations, on the other hand, are unlimited legal tender.

3. **Optional Money (Credit money)**

Optional money is that money which is ordinarily accepted by the people in final payments, but has no legal sanction behind it. Credit instruments like cheques, drafts, bills of exchange, promissory notes etc, are optional money. Credit money constitutes the major part of the money stock in hands of public.

4. **Money proper and Money of Account**

Money proper or actual money is that money which circulates in a country as a medium of exchange. It is the form of money in which the price contracts and debt contracts are discharged. General purchasing power is stored in terms of money proper. Benham calls

it ‘unit of currency’ and Seligman refers to it as ‘actual money’. Money of Account is “that in which debts and prices and general purchasing power are expressed.” It is the form of money in which the accounts are maintained and the value is measured.

5. **Commodity Money and Representative Money**

Commodity money is composed of some commodity (Rice or wheat, pulses) chosen as money. Representative money circulates in the form of cheap metallic coins or convertible paper notes. Representative money may either be representative full-bodied money, or representative token money. The former is convertible into full-bodied coins. The latter is inconvertible money which is termed as fiat money. It generally circulates as paper money and is issued by state and has no fixed values, Managed money is another sub-species of representative money. It is like a fiat metallic reserve. It is, thus a hybrid between commodity money and fiat money. It is the most common form of money in nearly all the countries.

Walker says, “Money is what money does”. It avoids the difficulties of Barter. The general features of money are general acceptability and scarcity. It oils the wheels of trade and industry. Money is defined in terms of its functions. The functions of money are classified as the primary functions, the secondary functions and the contingent functions. Kinley describes the primary functions as the ‘essential’ functions, and the secondary functions as ‘derived’ functions, whereas contingent functions are those which flow from the conditions of a particular economic state.”

FUNCTIONS OF MONEY

The functions of money are:

1. **Primary functions**
2. **Secondary functions**
3. **Contingent functions**

1.Primary Functions

(A) Medium of Exchange

The most striking characteristic of money is that it facilitates trade by providing a medium which everyone is willing to accept in exchange for goods and services or in payment’ function of money. Money is also referred to as ‘generalises purchasing power’ or ‘a bearer of options. The medium of exchange function can be served by anything which is generally or commonly accepted by people in exchange for the goods and services. The use of money as a medium of exchange has broken up an exchange of goods for goods into two transactions- purchases and sales. The use money has considerably facilitated exchange

transactions at all places and at all times. Money as a medium of exchange encourages price mechanism, productive operations, and determines the share of each factor of production in the output of the industry. It further encourages the division of labour and widens the market for products. It performs allocation function in the economy.

(B) Common Measure of Value

As a common measure of value, money expresses the values of all commodities. The common measure of value function of money has been given many names of which the most common are unit of value, standard of value, 'unit of account', and 'common denominator of value'. Each monetary unit is actually stated in terms of the unit of account. It serves as the unit interims of which the value of all goods and services is measured and expressed as a 'price'. The pricing mechanism, which helps us in measure of value function of money. It helps us to compare the value of goods and services. For example, there is Rs.10,000. One Fridge costs Rs.10,000. One Wet grinder costs Rs.5000. One Mixie costs Rs.2500.

With the help of Rs.10,000, one can purchase one TV or 2 wet grinders or four mixies. This is, 1 TV = 2 wet grinders = 4 mixies (with help of Rs.10.000). Thus, comparison is easily made.

2. Secondary Functions of Money

(A) Standard of the Deferred payments

Money comes into general use as a medium proper and as a unit of account not only for immediate transactions; it also serves as a standard of deferred payments when obligations to make future payments are stated in terms of it. These obligations have their origin in two general types of transactions. The first is that in which one contracting party agrees to deliver fixed amounts of good, services or securities at some future time in exchange for an agreed upon sum of money to be paid in future. The second type of transaction giving rise to the use of money as a standard of deferred payments which includes credit or debt transactions, in which the creditor parts with things of value at one time in return for which the debtor promises to repay money at some future date. In the modern economic society, people owe each other the great aggregate of debts. This has increased the importance of money as a standard of deferred payments.

(B) Store of value

Money is 'generalised purchasing power'. It is accepted at any time for any good or service and it remains constant interims of itself. Due to its being generally acceptable and valuable, money embodies value in its most general form. The holder of money may, either spend it or hold it for future. When money itself is retained or stored for any desired period

of time, it serves as a store of value. The store of value function of money therefore implies the shifting of purchasing power from the present to the future.

(C) Transfer of Value

An equally important faction of money is to help in the transference of value from one place to another and from one person to another. Thus money serves both for the time – transfer.

CONTINGENT FUNCTIONS OF MONEY

(a) It facilitates distribution of social income

(b) It helps in equalisation of marginal utility in expenditure

(c) It serves as basis of credit system.

(d) It is imparting a general form to different kinds of wealth.

STATIC AND DYNAMIC FUNCTIONS OF MONEY

1. Static functions

By its static functions, money serves as a passive technical device ensuring a better operation of the economic system. Static functions are the functions which are performed by money under all conditions without bringing about any change in the economic set-up. It is helpful in the fields of consumption, production, distribution, exchange, and public finance. By serving as a medium of exchange, a measure of value, a standard of deferred payments and as a store of value, it functions as the medium of price mechanism operations. It is through price mechanism that money helps to establish a balance between demand and supply, and reconcile the interests of producers and the consumes. The functions of money can, however, be performed efficiently only when its general purchasing power is secured against violent changes. In other words, the stability of value of money is an essential quality which enables money to fulfil its static factions properly.

2. Dynamic functions

` By its dynamic functions, money tends to exert a powerful influence on the economic entities like the trends of price level, volume of production and consumption, rate of saving and investment, level of employment and income, the distribution of wealth etc. Any change in the volume and velocity of money can lead to a rise or fall in the general price level, which tends to stimulate or discourage consumption as well in the general price level, which tends to stimulate or discourage consumption as well as production. Money, therefore, plays an important and active part in influencing economic trends through, the inadequacy or excess of its supply compared with the amount required for maintaining the stability of its value and the volume of economic activities.

An intelligent and progressive application of monetary system can help in better and fuller utilisation of the natural and human resources in the country. This will bring about an increase in national product and a higher standard of living. Moreover, Paul Einzig points out that deficit budgeting by a government are possible only in a money economy. Money performs its dynamic functions by serving as a means of distribution of social income, and also as a means of achieving justice in distribution. It also brings equalisation of marginal utility in expenditures, serves as a basis of credit system and imparts liquidity, mobility and uniformity to capital. The main objective of monetary policy is shaped in such a manner that money is made to serve as an open instrument for achieving the objectives of general economic policy. A clean appreciation of the dynamic functions of money will enable the monetary authorities to use money as an engine of economic and social progress.

3. Basic Purposes of Money

Money renders many useful services and also serves the following basic purposes by means of its functions.

a) The great wheel of circulation.
b) The great instrument of commerce
c) A unit of value
d) A medium of exchange
e) A standard of deferred payments
f) A store of value

SIGNIFICANCE OR ROLE OF MONEY

Money plays a vitally important role in the economy by exerting its influence on output and employment by affecting the prices of goods and services. It also influences the aggregate flows of saving and investment. It facilitates the distribution of a wide variety and large quantity of goods and services which characterise our present mode of living. It provides market organisation and facilities for determining prices.

1. Money in a capitalist economy

Money is the life blood of a capitalist economy. The capitalist economy can function smooth only in a monetary system. Price Mechanism, the main source of guidance, has to be expressed in terms of money. Capitalism gives importance to private property, freedom of choice, contract and enterprise which are the main features of a capitalist economy. Thus the growth of the money economy has made possible the growth of economic liberalism and the present-day capitalistic system. Money is the symbol of capitalism. Money is the basis of market pricing mechanism which induces producers to producers to produce those goods

which consumers want. It induces consumers to economise in the use of scarce resources of the community. It is through the pricing system that the conflicting decision of millions of people in the economy is reconciled and specialisation and exchange are efficiently organised without central direction. It is the price mechanism that mechanism that economic activates are adjusted to changes in tastes, technology and resources. Money is the sine qua non for conducting modern business. Businessmen are concerned, while planning their production activities, with the money costs of production and prices together with the resulting pecuniary profits. The decision of an entrepreneur whether or not he should start a new industry or expend an existing one depends on his delectations of pecuniary profit. The organiser uses money for construction of factory, for paying labour force and corps of administrative officials.

2. Money in an underdeveloped Economy

Money occupies an important place in an underdeveloped economy. With the help of economic planning, it provides for adequate Monetary resources to accelerate the ate of economic growth. Real resources in the underdeveloped countries are not so scarce as are the monetary resources. The government has to provide for adequate finance t accelerate the economic development of the country. It levies direct and indirect taxes on the people. The government has to depend upon foreign exchange resources to accelerate the rate of economic growth. The government may resort to import and export controls. It is, therefore, evident that government of an underdeveloped economy has to mobilise through various devices adequate monetary resources to accelerate the economic development of the country.

3. Money and Monetary and Fiscal policies

The government plays an important role in the economy and through its fiscal and monetary policies it affects the flows. It raises taxes and by borrowing from the public it helps in increasing the flow of money payments. Governments build and run schools and hospitals, enforce law and order in society in the absence of which bno economic activity is possible, purchase aeroplanes, construct roads, bridges and river valley projects. To perform these multi- various activities, a part of the flow of money payments is diverted in the formj of tax payments from the people to government trading. Government also collects fines in terms of money.

4. Money in a Socialistic Economy

The need for money in socialistic economy arises from the following important considerations.

1. For the operation of Price mechanism

2. For distribution of goods
3. For allocating scarce economic resources
4. For distribution of National income

Evils of Money

(A) Economic Evils

1. Overcapitalisation and overproduction
2. Strengthen capitalism
3. Becomes master
4. Leads to Trade cycles
5. Lack of stability in money value
6. Money and its purchasing power may not be synonymous

(B) Social Evils

1. Money has encouraged greed and acquisitiveness in man
2. Money creates the desire to exploit others
3. Money is responsible for the decline in spiritualism in modern society
4. Money has encouraged theft, dacoit, murders, frauds and other social evils.

Questions

1. What is barter? Discuss the difficulties in barter economy.
2. Define money? Explain the function of money.
3. Discuss the significance and role of money in an economy.

Lesson-2

Milton Friedman's Restatement of the Quantity Theory of Money

Objectives:

After going through this lesson, you should be able to understand the features of Milton Friedman's quantity theory of money, which will give a comprehensive understanding of different forms of wealth, demand function for money and criticisms of Friedman's restatement of the quantity theory of Money.

Structure:

1.1 Introduction

The traditional quantity theory of money developed by the classical economists establishing a proportional relationship between the money supply and price level. The Chicago school of economists headed by Professor Milton Friedman has been honoured with the Nobel Prize for economics in 1976. In his essay on "The Quantity Theory of money-A Restatement" in which the theory was connected and integrated with general price theory. The quantity theory of money is a theory of the demand for money, not of output, money income or prices. He stated that money is an asset or capital good. The restatement emphasizes the role of money as an asset and hence treats the demand for money as part of capital or wealth theory concerned with the composition of balance sheet or portfolio of assets.

Money being a kind of asset is demanded, like any other asset, by wealth owning units. Friedman begins with wealth as comprising all sources of income, including human beings, and relates the demand for money to total wealth and the expected future streams of money income obtainable by holding wealth in alternative forms.

Features of Milton Friedman's Theory

1. Milton Friedman stated that his quantity theory is a theory is a theory of demand for money. It is not a theory of output, money income or prices.
2. The demand for money by the wealth-owner is identical with that of the demand for any durable consumer good.
3. The demand for money is determined by three major factors viz.,
   a). Total wealth of the individual
   b). The price and return from different forms of wealth
   c). The tastes and preferences of the wealth owner.

4. According to Friedman, the real cash balance i e (M/P) is a commodity demanded by the wealth owner because it yields services to the persons who hold it. Thus money is an asset or capital good.

5. Wealth is defined as the one which includes all sources of income and income is the permanent income received from this wealth.

6. Permanent income is the average expected yield on wealth during its life time.

1.2 Different forms of wealth

Friedman considers five different forms in which wealth can be held, namely, (1). Money (M), (2). Bonds (B), (3). Equities (E), (4). Physical non-human goods (G), and (5). Human capital (H). The demand for money, in real terms, may be expected to be a function of total wealth. It is the total that must be divided among various forms of assets. Friedman specifies the following as the key determinants of this demand for money. (1). The total wealth, (2). The division of wealth between human and non-human forms, (3).The expected rates of return on money and other assets.

Wealth holders divide their total wealth in these five forms of wealth (except human capital) can be measured by the rate of interest that can be earned on such assets as bonds, equities, etc., and the expected rate of change in their prices. People hold more wealth when the rate of interest decreases or prices of such assets increase and vice versa. But under normal conditions, the interest elasticity of demand for money in negligible.

Different forms of wealth yield different forms of income. Money is a luxury good because it yields money return on the various components of money as currency, demand deposits and time deposits. It also yields real return in the form of convenience, security etc to the holder. The real return is measured in terms of the 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 'P' is an important variable in the demand function for money.

The nominal rate of return on bonds, equities and physical assets (Non-human goods0 consists of (a). Any currently paid yield or cost, such as interest on bonds, dividends on equities and cost of storage on physical assets and (b). Changes in their prices.

In the case of human wealth the rate of return cannot be measured because the conversion of human into non-human wealth or the reverse is subject to institutional constraints. But there is the possibility of substitution of one wealth into another. Friedman calls the ratios of non-human to human wealth as (W). According to Friedman, the level of permanent income (Y) and wealth (W) determine the income elasticity of demand for money which is greater than unity i.e the demand for money increases more than proportionately with the increase in income.

Variables other than wealth also affect the demand for money. These variables are the tastes and preferences of wealth-holders. Such variables are denoted by the symbol (U).

1.3. Demand Function for Money

After considering the variables affecting the demand for money, Friedman has explained the demand function for money and the function is stated below.

$$M= f (y,p,r_b,r_e,1/p. D_p/d_t,w,u) \quad \text{..... (1)}$$

M- the total money demanded

Y- the total permanent income

P-price level

r_b- yield on bonds

r_e- yield on equities

$1/p.d_p/d_t$- expected rate of change of prices of goods

w-ratio of non-human to human wealth

u- Tastes and preferences

This demand function for money leads to the conclusion that a rise in expected yields on different assets reduces the amount of money demanded by a wealth holder, and that an increase in wealth raises the demand for money.

1.4. Friedman's quantity equation similar to Classical and Cambridge Equations.

Friedman's demand for money equation can be transformed into an income determination equation by taking with it a stable velocity (V). Thus it becomes a reformulated version of the traditional quantity theory of money.

Equation (1) can be written as:

$M/Y=f\ (P, r_b, r_e, 1/p.d_p/d_t, w, u)$ .....(2)

(or)

$M= f\ (P, r_b, r_e, 1/p.d_p/d_t, w, u)\ Y$ .....(3)

Equation (30 is similar to the Cambridge cash balance equation M=KPY. Since, Friedman uses the symbol Y to denote money income PY, the Cambridge equation can be written as,

$M = KY$ .....(4)

But k= 1/V, so, the equation (4) becomes,

$M = (1/V)\ Y$

(or)

$Y = M/k$ which can be written as,

$Y = (1/k)\ M = VM$ (# 1/k =V) .....(5)

$Y = MV$ .....(6)

In equation (6) m also includes time deposits and Y is the permanent income. V = 1/k and k in Friedman's equation is f ((P, $r_b, r_e, 1/p.d_p/d_t$, w,n)

$1/k = 1/ f\ (P, r_b, r_e, 1/p.d_p/d_t, w, u)$

(or)

$1/k= v\ (P, r_b, r_e, 1/p.d_p/d_t, w, u)$

Equation (6) becomes,

$Y + V\ (P, r_b, r_e, 1/p.d_p/d_t, w, u)\ M$ .....(7)

In this form, Friedman's equation becomes the usual quantity theory equation, where V is the velocity of income. Thus Friedman's money income determination equation of quantity theory is a simplified form of Cambridge equation.

1.5. Critical Evaluation of Friedman's Approach

Friedman has shown by exhaustive statistical tests on U.S. data since 1897 that except for the 1930s, the quantity of money has been a better predictor of consumption than has autonomous spending. It has also shown that velocity of circulation is consistently more stable than the Keynesian multiplier.

The reformulation of quantity theory by Friedman emphasizes the role of money as an asset and hence treats the demand for money as part of capital or wealth theory. The emphasis on income as a 'surrogate' for wealth, rather than as a measure of the 'work' to be done by money, has led to the conceptual integration of wealth and income as influences on behaviour.

Friedman's main contribution to monetary theory lies in relating the demand for money income obtainable by holding wealth in alternative forms, both human and non-human.

Friedman has developed, in connection with the theory of consumption, the longer term concept of 'permanent income' and has applied it to his subsequent empirical work on the demand for money. In the words of Johnson, "The most important implication of Friedman's analysis, however, concerns not the formulation of monetary theory but the nature of the concept of 'income' relevant to monetary analysis".

Milton Friedman has tried to place money in the framework of a generalised theory of asset choice. His contribution lies in his empirical studies concerning the relation between the variations in the quantity of money and the price level and that between permanent income, permanent wealth and permanent consumption, his generalised Walrasian, though Marshall inspired approach regarding the relation between money and permanent wealth (and income), and his efforts to prove that velocity is not perversely behaved.

The following some of the criticisms against Friedman's approach

(i). Johnson has observed that Friedman's approach using the permanent income concept is very similar to theories employing lagged income as a determinant of behaviour. Jhonson emphasis the demand for money has interrelationship of income, wealth and interest.

(ii). Friedman's hypothesis is that the demand for money increases more rapidly than income. In his definition of money includes time deposits as well, it has been questioned by Latane on theoretical grounds. Moreover, Friedman's suggestion that money is a 'luxury' is highly misleading. Latne's findings do not corroborate the hypothesis that cash balances are akin to luxury goods and that income velocity falls as real per capita income increases.

(iii). Friedman has found empirically that the rate of interest has only a negligible effect as a determinant of the demand for money. He holds that changes in interest rates have been a minor factor for secular changes in velocity. The empirical studies conducted by Selden (1961), Duesenberry (1963), and Thompson (1954), have employed sectoral approach to ascertain whether the money holdings of various sectors are responsive to changes in interest rates.

1.6. Summary

From this lesson you have studied that the features of Milton Friedman's Theory Different forms of wealth such as (1). Money (M), (2). Bonds (B), (3). Equities (E), (4). Physical non-human goods (G), and (5). Human capital (H). The demand for money, in real terms, may be expected to be a function of total wealth. It is the total that must be divided among various

forms of assets. Friedman specifies the following as the key determinants of this demand for money. (1). The total wealth, (2). The division of wealth between human and non-human forms, (3).The expected rates of return on money and other assets. The demand functions for money. Moreover, it also discussed Friedman's Quantity equations similar to Cambridge equations. Finally, this theory was criticises by many economists in several grounds.

1.7. Terminal Questions

1. Explain Milton Friedman's restatement to the quantity theory of money
2. Milton Friedman's quantity theory is a demand theory of money-elucidate thus statement.
3. Critically analyse Friedman's Restatement of quantity theory of Money

Lesson-3

Classical Theories of Demand for Money

Objectives:

After going through this lesson, you should be able to understand the concept, nature of monetary economics which will give a comprehensive understanding of Monetary economics.

Structure:

3.1. Introduction

3.2. Classical Approach to Demand for Money

3.3 Assumptions

3.4 Criticisms

3.5 Summary

3.6 In text Questions

3.2. Classical Approach to demand for Money:

a) Fisher's Equation:

The classical economists did not explicitly formulate demand for money theory, but their views are inherent in the quantity theory of money. They considered only the medium of exchange function of money as an important one i.e., money as a means of purchasing of goods & services. The cash transactions approach was popularised by Irving Fisher of the USA in 1911, in his book 'Purchasing Power of Money'. Through his equation of exchange he made an attempt to determine price level and value of money. Symbolically, Fisher's equation of exchange is written as under

` $M'V' + MV = PT$ -------- (1)

Where M is the total quantity of money, M' is the credit money, V & V' is its velocity of circulation of money and credit, 'P' is the price level and, 'T' is the total amount of goods and services exchanged for money. This equation equates the demand for money (PT) to supply of money (MV). As mentioned earlier, he made an attempt to determine price level and value of money. Value of money is meant by purchasing power of money. In order to find out the effect of the quantity of money on the price level or the value of money we write the equation as:

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

As per the equation, price is positively associated and negatively influenced by the changes in T and value of money is also determined by the same variables but it has negative

association with M and the direct relation with T. In other words, if the quantity of money is doubled the price level will also double and the value of money will be one half. On the other hand, if one half reduces the quantity of money, one half will also reduce the price level and the value of money will be twice.

Panel A of fig shows the positive effect of the quantity of money on the price level and in panel B, the inverse relation between the quantity of money and the value of money is presented.

However, by taking some assumptions about the variables V & T Fisher transformed the quantity theory equation into a theory of demand for money.

According to Fisher, the nominal quantity of money is fixed by the central bank and is therefore, treated as an exogenous variable which is assumed to be a given quantity in a particular period of time. Further, the number of transactions in a period is a function of national income. Since, Fisher assumed full employment of resources prevailed in the economy; the level of national income is determined by the amount of the fully employed resources. Thus, with this assumption, the volume of transactions T is fixed in short run. Fisher made most important assumption which makes his equation as a theory of demand for money is that, velocity of circulation (V) remains constant and is independent of M, P and T. this is because he thought that velocity of circulation of money (V) is determined by institutional & technological factors involved in the transaction process.

If we want to be in equilibrium, nominal quantity of money supply must be equal to the nominal quantity of money demand. So that,

$$Ms = Md = M \text{ ------(2)}$$

Where M is fixed by central Bank.

With the above assumptions Fishers equation can be rewritten as

$$MD = \frac{PV}{V} \quad \text{or} \quad MD = \frac{1.PV}{V}$$

Therefore, according to Fisher, demand for money is depends on the following three factors: 1) The number of Transactions 2) The average price transfers 3) The velocity of circulation of money. This approach is faced some serious difficulties in empirical research 1) in this approach transactions are not only purchase of goods and services but also purchase of capital assets, so that when there is a scope for frequent changes in capital assets, it is not appropriate to assume that T will remain constant even if Y is taken to be constant due to full

employment assumption 2) it is difficult to define and determine a general price level that covers not only current goods and services but also capital assets.

3.3 Assumptions: Fisher's theory is based on the following assumptions.

1) 'P' is a passive factor in the equation of exchange which is affected by the other factors.
2) The proportion of M' to M remains constant.
3) V and V' are assumed to be constant and are independent of changes in M and M'.
4) T also remains constant and is independent of other factors such as M,M',V and V'.
5) It is assumed that the demand for money is proportional to the value of transactions.
6) The supply of money is assumed as an exogenously determined constant.
7) The Theory is applicable in the long run.
8) It is based on the assumption of existence of full employment in the economy.

The same theory is explained with the help of the following diagrammatic representation.

Figure

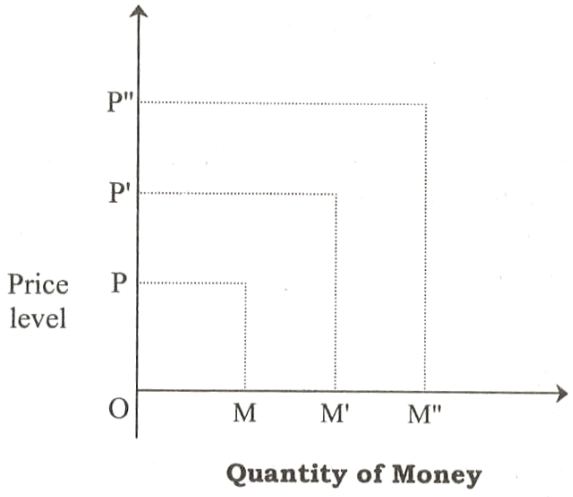


Figure (1) shows the effect of changes in the quantity of money. When the quantity of money is doubled from OM to OM" the price level is also doubled from OP to OP" and when it is halved to OM', then the price level is also halved to OP'.

Figure

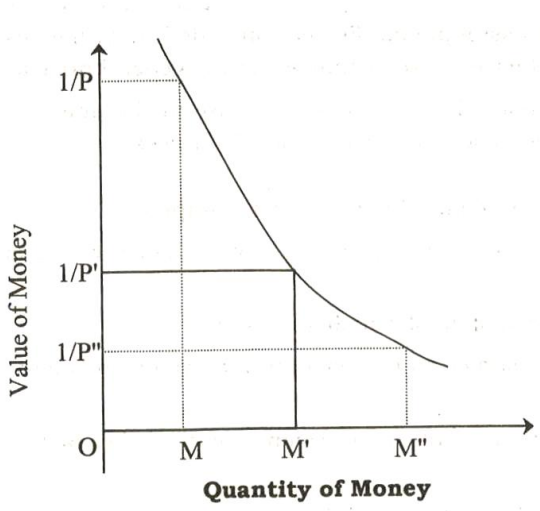


Figure (2) shows that the inverse relationship between the quantity of money and the value of money. At OM quantity of money, its value is 1/P, when the quantity of money is doubled from OM to OM" the value of money is halved from 1/P to 1/P". When the quantity of money is halved from OM" to OM' the value of money is doubled to 1/P. The downward sloping curve also shows this inverse relationship between the quantity of money and its value.

3.5 Criticisms

1) The assumptions of Fisher's equation that V and T remain constant and that is why any increase or decrease in 'M' causes a decrease or increase in P are not supported by facts.
2) The theory does not also explain the causes why prices and production behave in a different fashion in a trade-cycle.
3) The assumption that 'other things remain constant' is wrong because other things never remain constant and changes in any one factor causes changes in other factors well.
4) The equation does not provide adequate tools for analysing the factors which cause changes in the value of money.
5) The equation treats money as a medium of exchange, and overlooks the other important functions of money.
6) Preparation of accurate price index number is not possible.
7) Non-monetary factors may be stronger than the monetary factors.
8) " The changes in the price level are the root cause of trade cycles" is not wholly true because prices fall or increase due to the fall or increase in the demand and both prices and demand fluctuate under the influence of some other common factor.

9) The assumption "other things is static and constant" is unrealistic and does not explain the phenomenon of business cycles in real life.

10) One of the main weaknesses of Fishers quantity theory of money is that it neglects the role of the rate of interest as one of the causative factors between money and prices. Fisher's equation of exchange is related to an equilibrium situation in which rate of interest is independent of the quantity of money.

11) Keynes in his general theory severely criticised the Fisherian quantity theory of money for its unrealistic assumptions. First, the quantity theory of money is unrealistic because it analyses the relation between 'M' and 'P' in the long run. Thus, it neglects the short-run factors which influence this relationship. Second, fisher's equation holds well under the assumption of full employment. But Keynes regards full employment as a special situation. The general situation is one of under-employment equilibrium. Third, Keynes does not believe that the relationship between the quantity of money and the price level is direct and proportional. Rather, it is an indirect one via the rate of interest and the level of output. According to Keynes, "So long as there is unemployment, output and employment will change in the same proportion as the quantity of money, and when there is full employment, prices will change in the same proportion as the quantity of money". Thus, Keynes integrated the theory of output with value theory and monetary theory and criticised Fisher for dividing economics "into two compartments with no doors and windows between the theory of value and the theory of money and prices".

Further, Keynes pointed out that when there is under-employment equilibrium, the velocity of circulation of money 'V' is too highly unstable and would change with changes in the stock of money or money income. Thus, it was unrealistic for Fisher to assume 'v' to be constant and independent of 'M'.

12) Don Patinkin has criticised Fisher for failure to make use of the real balance effect, that is, the real value of cash balances which leads to increased spending and hence to rise income, output and employment in the economy. According to Patinkin, Fisher gives undue importance to the quantity of money and neglects the role of real money balances.

13) Prof. Halm criticised Fisher for multiplying 'M' and 'V' relates to a point of time and 'V' to a period of time. The former is a static concept and the latter a dynamic. It is, therefore, technically inconsistent to multiply two non-comparable factors.

3.6. In text Questions

1). State Fisher's equation on Quantity theory of Money

2). Explain Irving Fisher's Quantity theory of demand for Money

3). Criticise Cash Transactions version of Fisher.

Lesson-4

Cash Balance approach of Demand for Money

Structure

4.1 Introduction

Objectives

After going through this lesson, you should be able to understand the features of Cambridge Cash Balance theory of demand for money, which will give a comprehensive understanding of feature of cash balance approach, is that it makes the demand for money as function of money income alone. It criticises the cash balance approaches of demand for money.

4.2 The Cambridge Quantity theory:

Cambridge Cash Balance Theory of demand for money was put forward by Cambridge economists, Marshall, Pigou, and Robertson. It places emphasis on the function of money as a store of value or wealth instead of Fisher's emphasis on the use of money as a medium of exchange. Marshall, Pigou and Robertson focused their analysis on the factors that determine individual demand for holding cash balances. Although, they recognised that current interest rate, wealth owned by the individuals, expectations of future prices and future rate of interest determine the demand for money, they however believed that changes in these factors remain constant or they are proportional to changes in individual's income. Thus, they put forward a view that individual's demand for cash balances is proportional to the nominal income. Thus, according to their approach, aggregate demand for money can be expressed as

$Md = kPY$ ---------- (1)

Where Y=real national income; P = average price level of currently produced goods and services; PY = nominal income; k = proportion of nominal income (PY) that people want to hold as cash balances.

Demand for money in this equation is a linear function of nominal income. The slope of the function is equal to k, that is, $k = Md/Py$, thus important feature of cash balance approach is that it makes the demand for money as function of money income alone. A merit of this

formulation is that it makes the relation between demand for money and income as behavioural in sharp contrast to Fisher's approach in which demand for money was related to total transactions in a mechanised manner.

We can observe the Cambridge approach even by the equations of individual economists. Marshall's formula is as follows:

M = KY ---------- (2)

Where M is the quantity of money, Y is the total money income and K is the co-efficient whole function is to bring the two sides into balance.

Pigou expresses the form of an equation as:

$$P = \frac{KR}{M} \text{ or } \frac{M}{KR} \text{ ----------(3)}$$

Where P stands for the value of money or its inverse the price level (M/KR), M represents the supply of money, R the total national income and K represents that fraction of R for which people wish to keep cash.

Pigou presents the equation in an extended form by dividing cash into two parts: cash with the public and, deposits which the people consider as cash, therefore:

P = KR/M{C+h (1-c)} ----------(4)

Where, C denotes cash with the public (1-c) stands for bank deposits and H denotes the percentage of cash reserve against bank deposits. If we assume the total amount of money in the community as 1, the public as cash holds the public holds part of it and balance as deposits in banks. Banks do not keep the entire deposits as cash only a portion or a part of it is kept as cash and is denoted by 'h'. Therefore, C+h (1-c) shows the amount of money in the economy at any time denoting the proportion of cash and h(1-c) denoting it proportion of bank deposits.

Prof D H Roberstson's equation is similar to that of Prof Pigou's with a little difference. Roberson's equation is:

M = PKT or P = M/KT ----------(1)

Where P is the price level, T is the total amount of goods and services K represents the fraction of T for which people wish to keep cash. Robertson's equation is considered better than that of Pigou as it is more comparable with that of Fisher. It is the best of all the Cambridge equations, as it is the easiest.

Glay writes,' Cambridge approach is conceptually richer than the transactions approach, the former is incomplete because it does not formally incorporate the influence of economic

variables must mentioned on the demand for cash balances, Keynes attempted to eliminate this shortcoming.

Another important feature of Cambridge demand for money function is that the demand for money is proportional function of nominal income. Thus, it is proportional function of both price level and real income. This implies tow things, first income elasticity of demand for money is unity and secondly price elasticity of demand for money is also equal to unity so that any change in the price level causes equal proportionate changes in the demand for money.

4.3 Summary

Quantity theory of money seeks to explain the value of money in terms of changes in its quantity. In other words, quantity theory of money says that the level of prices varies directly with quantity of money. In this regard there are three theories, one is cash transactions theory which was developed by considering medium of exchange is a function of money, second one is cash balances approach based on the store value as a function of money and, thirdly Keynes theory of liquidity preference.

4.4 Terminal Questions

4.5 In text Questions

1) Discuss the cash balance approach of demand for money
2) Criticise Cash balance Approach
3) Explain why Cash Balance approach is superior to Fisher's equation

Lesson-5

Keynesian and Post-Keynesian Theories of Demand for Money

Structure

5.1 Introduction

Keynes propounded a theory of demand for money in his general theory which occupies an important place in his monetary theory. In other words his demand for money is called as liquidity preference. How much of his income or resources will a person hold in the for of ready money and how much will he part with or lend depends upon what calls his 'liquidity preference'. Liquidity preference means the demand for money to hold or the desire of the public to hold cash. Keynes suggested three motives which led to the demand for money in an economy they are: the transactions motive, Precautionary motive and Speculative motive.

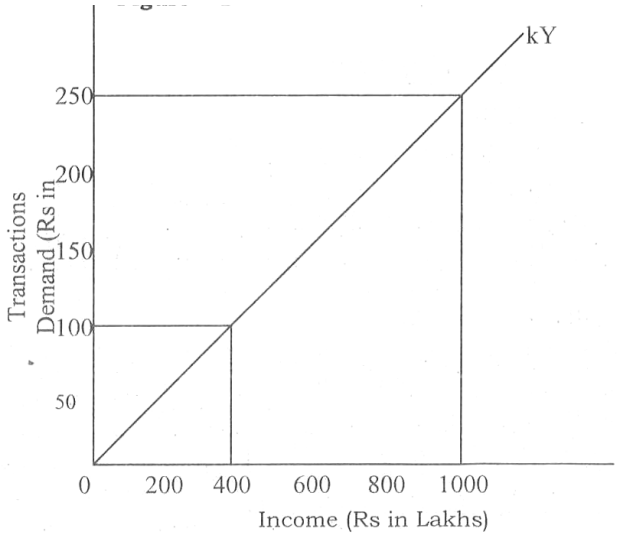
5.2 Keynes Liquidity Preference Approach

5.2.1 The Transactions Demand for Money:

The transactions demand for money arises from the medium of exchange function of money in making regular payments for goods and services. According to Keynes, it relates to 'the need of cash for the current transactions of personal and business exchange'. Further, he stated that the changes in transactions demand for money depending upon the changes in income. Therefore, the transactions demand for money is a direct proportional and positive function of the level of income, and is expressed as :Lt = f(ky) where Lt is the transactions

demand for money, k is the proportion of income which is kept for transactions purposes, and y is the income. This equation is illustrated in the following diagram;

Regarding the rate of interest and transactions demand for money, Keynes made the Lt function interest inelastic. But he did not stress the role of the rate of interest in this part of his analysis, and many of his popularizers ignored it altogether. In recent years, two post Keynesian economists WJ Baumol and James Tobin have shown that the rate of interest is an important determinant of transactions demand for money. they have also pointed out that the relationship between transactions demand for money and income is not linear and proportional . Rather changes in income lead to proportionately smaller changes in transactions demand. The modern view is that the transactions demand for money is a function of both income and interest rates which can be expressed as: Lt = f(Y,r) because, as the rate of interest starts rising over and above certain level the transactions demand for money becomes interest elastic. It is because the higher rates of interest will attract some amount of transactions balances into securities. So the backwards lope of Y curve shows that at still higher rates, the transaction demand for money declines. When there is a rise in income level, the level of decline in transactions balances at the same rate of interest is comparatively low. Thus, the transactions demand for money varies directly with the level of income and indirectly varies with the rate of interest. Fig



5.2.2.The Precautionary demand for money:

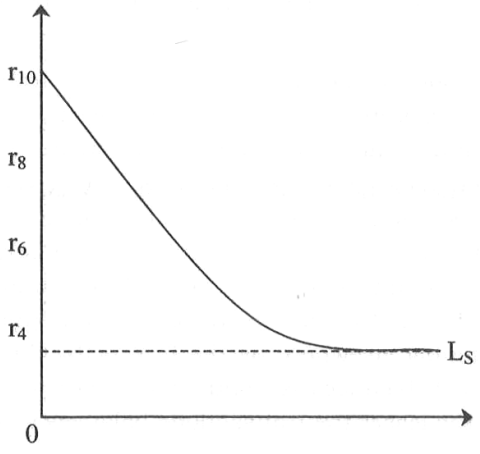
The precautionary motive relates to “the desire to provide for contingencies requiring sudden expenditures and for unforeseen opportunities of advantageous purchases”. Both individuals and businessmen keep cash in reserve to meet unexpected needs. Individuals hold some cash

to provide for illness, accidents and other unforeseen contingencies. Similarly, businessmen keep cash in reserve to tide over unfavourable conditions or to gain from unexpected deals. The precautionary demand for money depends upon the level of income, and business activity, opportunities for unexpected profitable deals, availability of cash, the cost of holding liquid assets in bank reserves etc. Keynes held that the precautionary demand for money, like transactions demand, was unction of the level of income. But the post-Keynesian economists believe that like transactions demand, it is inversely related to high interest rates.

5.2.3. The Speculative Demand for Money:

The speculative demand for money is for 'securing profit from knowing better than the market what the future will bring froth' Individuals and businessmen having funds, after keeping enough for transactions and precautionary purposes, like to make a speculative gain by investing in bonds. Money held for speculative purposes is a liquid store of value, which can be invested at an opportune moment in interest – bearing bonds or securities.

According to Keynes, it is expectations about changes in bond prices or in the current market rate of interest that determine the speculative demand for money. In explaining the speculative demand for money, Keynes had a normal or critical rate of interest in mind. If the current rate of interest is above the critical rate of interest, businessmen expect it to fall and bond price to rise. They will, therefore, by bonds to sell them in future when their prices rise in order to gain thereby. At such times, the speculative demand for money would fall, conversely, if the current rate of interest happens to be below the critical rate businessmen expect it to rise and bond prices to fall.



Speculative demand for money

Thus, the speculative demand for money is a decreasing function of the rate of interest. The higher the rate of interest, the lower the speculative demand for money, and the lower the rate if interest, the higher the speculative demand for money. It can be expressed algebraically as

Ls = f ®, where Ls is the speculative demand for money and r is the rate of interest. Thus, the Keynesian speculative demand for money function ishighl6y volatile, depending upon the behaviour of interest rates.

5.3 The total Demand for Money:

According to Keynes, money held for transactions and precautionary purposes its primarily a function of the level of income, Lt = f(Y), and the speculative demand for money is a function of rate of interest, Ls = f®. Thus the total demand for money is a function of both income and interest rate. L = f (Y,r)

Where L represents the total demand for money. Thus the total demand for money can be derived by the lateral summation of the demand function for transactions and precautionary purposes and the demand function for spec8ulative purposes, as illustrated in figures

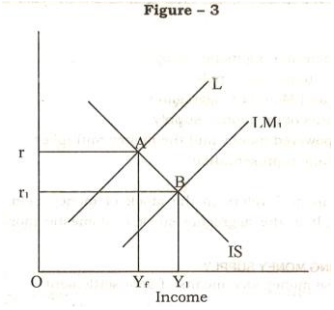
Panel A of the figure shows OT, the transactions and precautionary demand for money at Y level of income and different rates of interest. Panel B shows the speculative demand for money at various rate of interest. It is an inverse function of the rate of interest. For instance, at r6 rate of interest it is OS and as the rate of interest falls to r2, the Ls curve becomes perfectly elastic. Panel C shows the total demand curve for money L which is a lateral summation of LT and Ls curves: L = LT + Ls. Total demand for money also becomes perfectly elastic showing the position of liquidity trap.

5.4 Derivation of LM Curve

The LM curve can be derived from Keynesian theory from his analysis of money market equilibrium. According to Keynes, demand for money to hold depends on Transaction and speculative motive. It is the money held for transactions motive which is the function of income. The demand for money also depends on the rate of interest which is the cost of holding the money. This is because by holding money rather than lending it and buying other financial assets, one has to forego interest. The intersection of the various money demand curves corresponding to different income levels with the supply curve of money fixed by the monetary authority would give us the LM curve. LM curve related the level of income with the rate of interest which is determined by money market equilibrium corresponding to different level of demand for money. The LM curve tells what the various rates of interest will be (given the quantity of money and family of demand curves of money) at different levels of income. But the money demand curve or what Keynes called liquidity preference curve alone cannot tell us what exactly the rate of interest will be. In figure, we have derived LM curve from a family demand curves for money. As income increases, money demand curves shifts outward and therefore, the rate of interest which equates supply of money with

demand for money rises. In figure (B) we measure the income on the X axis and plot the income level corresponding to the various interest rates determined at those income levels through money markets equilibrium by the quality of demand for and the supply of money in figure (A).

Figure – 3



Summary

Keynes in his theory stated that the demand for money arises for three motive; transactions motive, precautionary and speculative motive. According to Keynes the total demand for money means total cash balances which may be of two types: active and idle balances. The former comprises transactions and precautionary demand and the later comprise speculative demand. Both the transaction and precautionary demand are positively associated with the changes in the money income but change in rate of interest no role to play in determining transaction and precautionary demand. Speculative demand for money is negatively associated with the changes in the rate of interest. Finally, Keynes held that the total demand for money is determined by both interest and income.

5.5 Post-Keynesian Approach to Demand For Money

5.5.1. Don Patinkin's Real Balances Effect:

Don Patinkin developed Real Balances approach, by criticising the cash balances approach of Cambridge economists approach on the basis of two grounds 1) homogeneity postulation 2) dichotomisation of goods & Money markets. In his approach reconciles the two markets through the real balance effect. Homogeneity postulate means that a doubling of money prices will have no effect on the demand supply of goods. Mathematically, the demand and supply function for goods are homogeneous of degree zero in prices. So that Patinkin criticises the postulate for its failure to have any determinate theory of money and prices.

Dichotomisation means that the relative price level is determined by the demand and supply of goods and the absolute price level is determined by demand and supply of money. So that the effect of price has no effect on the monetary sector and monetary prices in turns has no influence on the real sector of the economy. But, he criticised it and integrates the money

market with goods market, with depend on real balance but not one relative price. Real balances mean the real purchasing power of the stock cash holdings of the people.

According to him, demand for a community depends on both the real balances and relative prices, therefore, when the price level rises or declines this will reduce/increase the real balances of the people respectively. When price level rises it creates state of involuntary unemployment but it will not last continuously because a wages and prices fall the full employment level of output and income will be restored.

Don Patinkin also introduces the real balances effect in general equilibrium analysis. According to him absolute prices play a crucial role not only in the money but also in the real sector. Further he said that 'Once the real and monetary data of an economy with outside money are specified, the equilibrium values of relative prices, the rate of interest and the absolute price level are simultaneously determined by all the markets of the economy. It is generally impossible to isolate a subset of markets, which can determine the equilibrium values of a set of prices.

Patinkin also validates the quantity theory conclusion, he pointed out that the real balance effect implies that people do not suffer from 'money illusion' they are interested only the real value of their cash holdings. Therefore, Patinkins analysis is a real improvement on the traditional quantity theory and its value lies in the integration of commodity and money markets through the real balance effect.

5.5.2 Critical evaluation of Don Patinkin's Real Balances Effect:

1). Archibald and Lipsey consider Patinkins treatment as quite inadequate because it fails in the determination of long run equilibrium.

2). Patinkin has failed in providing a proper explanation of the manner in which the monetary wealth gets increased.

3). Gurley.J.G and Shaw. E.S have also criticised the static assumptions of Patinkin and have enumerated and elucidated the conditions to show under which money will not be neutral.

5.5.3 Baumol's Inventory Theoretic Approach to the Demand for Money:

As mentioned earlier, in recent years, an alternative theories on demand for money developed by Baumol, Tobin and Milton Friedman. Particularly, Baumol and Tobin models are developed based on the conclusions derived by Keynes in his demand for money theory. Keynes believed that the transactions demand for money was primarily interest inelastic and the speculative demand for money is determined by the relative yield on assets in an individual's portfolio. Has limited his analysis only to bonds and money. Thus, this combination of demand motives with two different approaches has been responsible for the

criticism at the hands of Baumol and Tobin. Therefore, Baumol has analysed the interest elasticity of the transactions demand for money and Tobin has explained liquidity preference as behaviour towards risk. The third approach by Friedman explains that the demand for money is not merely a function of income and the interest rate, but also of total wealth.

Theory:

Baumol's analysis is based on the holding of an optimum inventory of money for transactions purposes by a firm or an individual. In his model he has shown that the relation between transactions demand for money and income is neither linear nor proportional as was stated by JM Keynes. Rather, changes in income lead to less than proportionate changes in the transactions demand for money, further he analyses that the interest elasticity of the transactions demand for money. To substantiate the argument, he stated that the cash balances maintain by a firm is to purchase of labour, raw material etc., but it is expensive to tie up large amounts in the form of cash balances, therefore, money could be invested profitably in securities thus, the lesser would be the account for transaction balances the higher the interest rate on securities.

According to Baumol, the holding of cash balances involves two types of costs a) Interest Costs b) Non-Interest costs. Holding cash balances mean that the individual foregoes interest by not investing into other interest yielding assets. This is the interest cost to the individual money holder. When bonds are converted into cash the investor has to meet certain costs like brokerage fee, postal changes etc., there are known as non-interest costs. Thus, whenever, a firm holds transaction balances it incurs interest costs as well as no interest costs, similarly, the interest on bonds also incurs non-interest costs, to the individual and firm. Therefore, the firm or an individual has to maintain balance between the incomes to be foregone through fewer bond purchases against the expenses to be incurred by making larger investments in bonds. The higher the rate of interest, the larger the expenses a firm can bear in making bond purchases. Another important factor which will affect the is will be the amount of money involved in these t transactions, because the brokerage fees are relatively fixed. When the money involved in these transactions is larger, the smaller will be the brokerage fees, the larger the total amount involved the less significant will be the brokerage fees, because of the operation of economies of scale. This means that at higher levels of income the average cost of transactions is lower. With an increase in the level of income the transactions demand for money also increases but this increase would be less than increase in income. Since Baumol takes the income elasticity of demand for money as one half but the demand for money will not increase proportionately to the increase in income. In any case, an

increase in income would lead to larger investments in bonds and the investor will enjoy the economies of scale Baumol also emphasis in this connection, the importance of demand for real balances, According to Baumol the demand for real balances "is proportional to the square root of the volume of transactions and inversely proportional to the square root of the rate of interest". Hence, the relationship between price level and the transactions demand for money is direct and proportional. If the price level doubles, the money value of the transactions will also be doubled. When all prices doubled brokerage fees will also be doubled so people would like to hold high cash balances and avoid investments and withdrawals and brokerage cost which they would otherwise incur hence, the increase in the money value of transactions and in brokerage fees brings about arise in the optimal demand for money in exactly the same proportion as a change in the price level.

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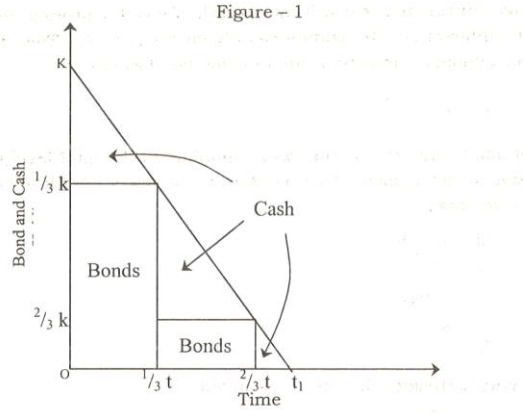
Figure – 1



Is Baumol' s analysis superior to the classical and Keynesian approaches?

Baumol's approach is superior to earlier approaches in the following respects.

1. Earlier approaches assume the relationship between the transactions demand and the level of income as linear and proportionate. Baumol held that transactions demand does increase with the increase in income, but less than proportionately.
2. Keynes held that the transactions demand for money is interest – inelastic, while Baumol has established that it is interest-elastic.
3. While analysing the transactions demand for money Baumol has emphasised the absence of money illusion.
4. Finally, Baumol's analysis integrates the transactions demand for money with the capital theory approach by including assets and their interest and non-interest costs.

5.5.4 Tobin's Risk Aversion Theory of Liquidity Preference

James Tobin formulated the risk aversion theory of liquidity preference based on portfolio selection. This theory removes two major defects of the Keynesian theory of liquidity preference (1). Keynes, liquidity preference function depends on the elasticity of expectations of future interest rates and (2). Individuals hold either money or bonds. Tobin's theory does not depend on the elasticity of expectations of future interest rates but his theory is based on the assumption that the expected value of capital gain or loss from holding interest-bearing assets is always zero. His theory also explains that an individual's portfolio holds money and bonds rather than only one at a time.

Tobin starts his portfolio selection model of liquidity preference with the assumption that an individual asset holder has a portfolio of money and bonds. Money neither brings any return nor imposes any risk on him. But bonds yields interest also brings income. However, income from bonds is uncertain because there is a capital loss or gain in holding bonds. The greater the investment in bonds, the greater is the risk of capital loss from them. The risk attached to a portfolio is measured by the standard deviation of R, that is sigma

Jame's Tobin formulated the Risk aversion theory of liquidity preference based on Portfolio Selection. According to him, an investor is faced with a problem of what proportion of his portfolio of financial assets he should keep in form of money and interest bearing bonds. This theory removes two major defects of the Keynesian theory of liquidity preference. First one, Keynes function depends on the in elasticity of expectations of future interest rates and Second one, an individual hold either money or bonds. But according to Tobin, individuals are uncertain about future rate of interest, and an individual's portfolio holds money and bonds rather than only one at a time. Moreover his analysis's based on the assumption that the expected value of Capital loss or gain from holding interest bearing assets is always zero. According to him, money neither brings any income nor does it imposes any risk on the individual asset holder. Bonds do yield interest so as income. It is however uncertain and involves a risk of loss or gain.

He categorised the investors into three categories. They are: 1) risk lovers who enjoy putting all their wealth into bonds to maximise risk, they accept risk of loss in exchange for the income they expect from bonds. They will either put all their wealth into bonds or will keep it in cash. The second category is plungers. They will either put all their wealth into bonds or will keep it in cash. Third category investors are risk averters. They prefer to avoid the risk of loss that is associated with holding bonds rather than money. Such investors always diversify their portfolios and hold both money and bonds. Tobin in his model, for finding out different

averter's preference between risk and expected return, has used indifference curves having positive slopes, indicating that the risk averters expect greater returns in order to bear more risk. This is illustrated in Figure.

Figure-2

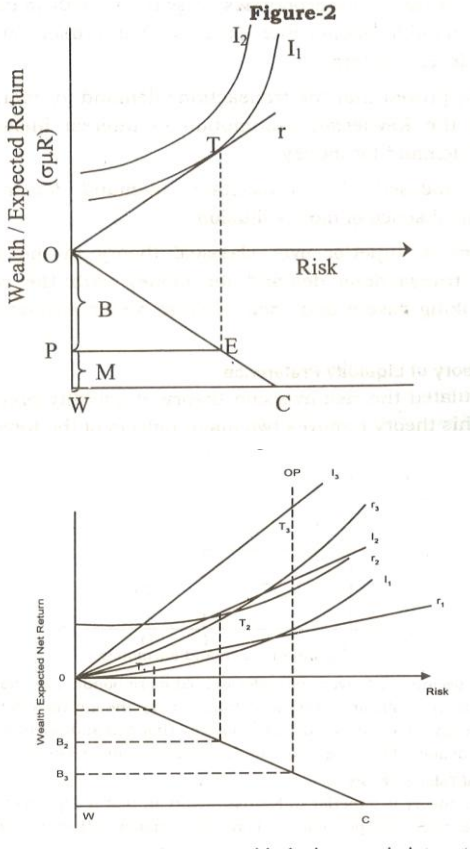
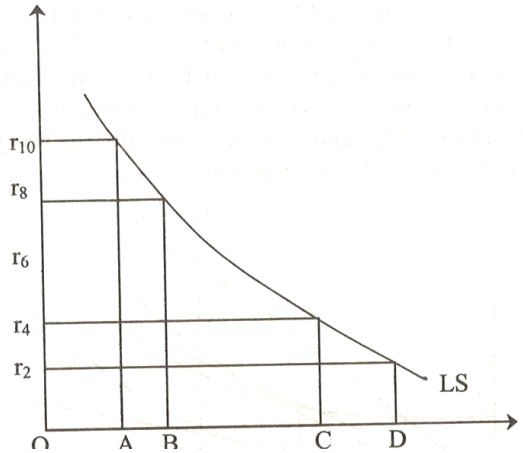


Figure – 4



In Figure, the vertical axis measures the expected returns while the horizontal axis measures risk OB is the budget line of the risk averter. OB line shows the various combinations of risks and expected returns on the basis of which he arranges his portfolio consisting of money and bonds. Ic and Ic' are indifference curves. Averter is indifferent between all combinations of expected returns and risks that each point on these indifference curves represents. Combinations shown on Ic' curve are preferred to those of Ic, but the averter will achieve

equilibrium at the point 'T' where his budget line is tangent to the indifference curve Ic. In the lower portion of the diagram the vertical axis shows the wealth held by the risk averter in his portfolio and the line OR shows the risk as proportional to the share of the total portfolio held in bonds. Point E on OR line represents the portfolio mix of money and bonds that is OM (bonds) and MW(money). Hence, the risk averter diversifies his total wealth OW by putting partly in bonds and partly in cash. In any case, he has a preference for liquidity, which can only be offset by higher rates of interest. At higher rate of interest, the demand for money will be lower and the incentive to invest into more bonds will be greater. The opposite will happen in the case of lower interest rates. At the outset, Tobin considers his theory is more sophisticated theory of liquidity preference than the Keynesian theory. Because his theory starts with the assumption that the expected value of capital gain or loss from holding interest-bearing assets is always zero. Further, it is more practical oriented approach because it explains that individuals and firm diversify their portfolios and hold both money and bonds and not money or bonds. And he does not agree with the view that at very low rates of interest the demand for money is perfectly elastic. In this respect he is more practical than Keynes.

5.5.5 Summary:

Classical stated that the effect of price has no effect on the monetary sector and monetary prices in turns have no influence on the real sector of the economy. But, Patinkin criticised it and integrates the money market with goods market, which depend on real balance but not on relative price. Baumol's analysis is based on the holding of an optimum inventory of money for transactions purposes by a firm or an individual. In his model he has shown that the relation between transactions demand for money and income is neither linear nor proportional as was stated by JM Keynes. Tobin's theory removes two major defects of the Keynesian theory of liquidity preference. First one, Keynes function depends on the inelasticity of expectations of future interest rates and Second one, an individual's hold either money or bonds. But according to Tobin, individuals are uncertain about future rate of interest, and an individual's portfolio holds money and bonds rather than only one at a time.

5.5.6. In text questions

1). Explain Keynes approach to the demand for Money?

2). Compare the classical and Keynesian approaches to Money

3). Explain Keynesian theory of Employment

4). How does Keynesian theory of liquidity preference explain the determination of interest rate?

5). Write a note on Keynesian Monetary theory

6). Distinguish between Monetarism and Keynesianism

7). Elucidate Don Patinkin's Real Balances Effect

8). Explain how Baumol' s analysis superior to the classical and Keynesian approaches?

9). Discuss Tobin's Risk Aversion Theory of Liquidity Preference

Lesson-6

Monetary Policy

Structure

6.1 Introduction

Monetary policy refers to credit control measures adopted by the central bank of a country. Johnson defines monetary policy " as policy employing central bank's control of the supply of money as an instrument for achieving the objectives of general economic policy G.K.Shaw defines monetary policy as " any conscious action undertaken by the monetary authorities to change the quantity, availability or cost of money.

6.2. Instruments of Monetary Policy

The instruments of monetary policy are of two types i.e quantitative and qualitative. They affect the level of aggregate demand through the supply of money, cost of money and availability of credit of the two types of instruments, the first category which includes (1). Bank rate variations, (2). Open Market Operations and (3). Changing Reserve requirements. They are meant to regulate the overall level of credit in the economy through commercial banks. The selective controls aim at controlling specific types of credit. They include changing margin requirements and regulation of consumer credit.

6.2.1. Bank Rate Policy

The bank rate is the minimum lending rate of the central bank at which it rediscounts first class bills of exchange and government securities held by commercial banks. When prices are depressed, the central bank lowers the bank rate. It is cheap to borrow from the central bank on the part of commercial banks. The latter also lower their lending rates. Businessmen are encouraged to borrow more investment is encouraged. Output, employment, income and demand start rising and the downward movement of prices is checked.

6.2.2. Open Market Operations

Open market operations refer to the sale and purchase of securities in the money market by the central bank. When prices are rising and there is need to control them, the central bank sell securities, the reserves of commercial banks are reduced and they are not in a position to lend more to the business community. Further investment is discouraged and the rise in prices is checked. Contrariwise, when recessionary forces start in the economy, the central bank buys securities. The reserves of commercial banks are raised. They lend more. Investment, output, employment, income, and demand rise, and fall in prices is checked.

6.2.3. Changes in Reserve Ratio

Every bank in required by law to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults and also a certain percentage with the central bank. When prices are rising, the central bank raises the reserve ratio. Banks are required to keep more with the central bank. Their reserves area reduced and they lend less. The volume of investment, output, and employment are adversely affected. In the opposite case, when the reserve ratio is lowered, the reserves of commercial banks are raised. They lend more and the economic activity is favourably affected.

6.2.4 Selective Credit Controls

Selective credit controls are used to influence specific types of credit for particular purposes. They usually take the form of changing margin requirements to control speculative activities within the economy. When there is brisk speculative activity in the economy or in particular sectors in certain commodities and prices start rising, the central bank raises the margin requirement on them. The result is that the borrowers are given less money in loans against specified securities. In case of recession in a particular sector, the central bank encourages borrowing by lowering margin requirements.

For an effective analytical monetary policy, bank rate, open market operations, reserve ratio, and selective credit control measures are required to be adopted simultaneously. But, it has been accepted by all monetary theorists that (i).the success of monetary policy is nil in a depression when business confidence is at its lowest ebb. and (ii). It is successful against inflation. The monetarists contend that as against fiscal policy, monetary policy has greater flexibility, and it can be implemented rapidly.

6.3. Monetary Policy in India

Monetary policy established on 1st April 1935, the Reserve Bank of India is the central bank in India. As the country's central bank of India, it is the apex monetary and financial institution responsible for the efficient working of the monetary mechanism which

is indispensable for the rapid development of country's economy. Reserve bank of India performs numerous functions. One of these functions is the regulation and control of the aggregate money supply-currency and credit- in the economy.

The Banking Regulation Act, 1949 is an important landmark in the history of central banking in the country. Before the passing of this Act, the reserve Bank of India possessed mainly two instruments to control the operations of the money market in the country, namely, to lend the banks at the bank rate or to discount eligible bills of exchange and to engage in the open market operations, i.e., to buy and sell the approved securities in the market. The reserve Bank of India now possesses extensive powers to control the operations of banks in India by determining their lending policy, commercial papers which they can accept as collateral securities against loans, ceiling and the floor rates of interest which they can change on loans and advances, maximum rates of interest which they must pay on different categories of deposits, net liquidity ratio which banks must maintain in order to be eligible to borrow funds from the Reserve Bank of India at the bank rate etc. the reserve bank of India can also prevent the banks generally or any particular of bank from making certain types of investments.

The monetary policy pursued by the Reserve Bank of India has been realistic with the bank sitting on the credit with-board releasing additional flow of credit when the genuine credit needs of the economy cannot be adequately met and cutting back the credit flow when it experiences surfeit of credit by employing the appropriate levels of credit control. These different tools of credit control have frequently been employed simultaneously. For example, effective from 17th February, 1965 simultaneously with the raising of the bank rate from 5 to 6% the minimum statutory net liquidity ratio for the scheduled banks was also raised from 28% to 30%. Now, we can briefly survey the monetary policy pursued by Reserve Bank of India since 1951.

1) The rise in money supply with the public and a substantial fall in aggregate scheduled bank credit during 1951-52.
2) The open money policy in November, 1951
3) Busy expansion in bank credit during 1951-52
4) Broadening of the economic activity with the industrial and agricultural production touching the record level.
5) Larger contraction in the aggregate bank credit in the slack season of 1952
6) During 1955, a high level of economic activity and consequent expansion in the banking activities

7) During the first five year plan (1951-56), a moderately restrictive monetary policy
8) During second plan period (1956-61), the supply of broad money (M3) increased man average annual rate of 8.2 percent
9) During third plan period (1961-66), the credit policy was liberalised, and broad money supply grew at the annual rate of 9%.
10) During 1970, the monetary policy of the Reserve bank of India was tightened selectively in order to curb the inflationary pressures in the economy.
11) During 1972, the policy of selective credit restraint
12) During 1973, the policy of checking the excessive bank credit
13) The monetary policy of RBI during 1974-75, busy season was essentially a continuation of status quo except some relaxation on a selective basis for sustaining investment, augmenting production and facilitating the distribution of essential commodities.
14) The policy of monetary restraint during 1976-79
15) Tightening of credit expansion during 1978-79
16) During 1980-81, high rate of monetary expansion
17) During 1991-92, the broad money supply (M3) grew faster than in the previous year primarily due to the substantial build-up in foreign exchange reserves.
18) Control of double digit inflation during 1993-95
19) During 1996-97, the twin considerations of ensuring to meet the genuine and legitimate credit requirements of the commercial sector and to consolidate the hard-won gains against inflation in 1995-96.

6.4. RBI's Objectives of Monetary Policy:

1. Price Stability
2. Growth, and
3. Social Justice

6.5. RBI and Monetary Policy:

The monetary policy sine 1952 emphasised the twin aims of the economic policy of the government.

i. Speed up economic development in the country to raise national income and standard of living and
ii. To control and reduce inflationary pressure in the economy.

To control inflationary pressure since 1972, RBI was to abandon 'controlled expansion and adopt the policy of credit restraint or tight monetary policy. The other

measures are general credit controls such as bank rate, statutory liquidity requirements (SLR) and open market operations of RBI.

In case of selective and direct credit control, under the banking regulation act 1949, section 21 empowers RBI to issue directives to the banking companies regarding their advances. These directives may relate to

1. The purpose for which advances may or may not be made
2. The margins to be maintained in respect of secured advances
3. The maximum amount of advance to any borrower
4. The maximum amount up to which guarantees may be given by the banking company on behalf of any firm, company etc., and
5. The rate of interest and other terms and conditions for granting advances.

Many other direct controls have also been imposed by RBI on the nationalised banks in the matter of their credit operations. Generally uses three kinds of selective credit controls.

a) Minimum margins for lending against specific securities
b) Ceiling on the amounts of credit for certain purposes, and
c) Discriminatory rate of interest charged on certain types of advances.

While imposing selective controls, RBI generally takes great care that bank credit for production and transportation of commodities and exports is not affected.

Selective controls are focussed mainly on credit to traders for financing inventories (for purposes of hardiness and speculation). There are two schemes in connection with monetary policy of RBI. They are given below.

1). Credit Authorisation Scheme (CAS)

The Credit Authorisation Scheme was first introduced by RBI on November 1965. Under this scheme, the commercial banks had to obtain RBI's authorisation before sanctioning any fresh credit of Rs.1 Crore or more to any single party. CAS was further liberalised in July 1987 to allow for genuine demands in production sectors without prior sanction of RBI. Under the scheme, RBI required the commercial banks to collect examine, and furnish detailed data regarding the borrowing concerns. Banks are also required to ascertain the working of the borrowing concerns on such matters as inter-corporate lending or investment, excessive inventory build-up. Diversion of short-term funds for acquisition of fixed assets etc. the aim was that banks should lend on the basis of the borrowing concerns with a view to de-regulate and liberalise the financial system in the country, RBI took a series of steps after 1987. One of the major steps taken by RBI was to abolish CAS in October 1988.

2). Credit Monitoring Arrangement (CMA)

However, to ensure that the basic financial discipline continued to be observed by banks, RBI would monitor and scrutinise all sanctions of bank loans (a). Rs. 5 crores to any single party for working capital requirement (b). Rs. Crores in the case of terms of loans. This post-sanction scheme has been designated on credit monitoring arrangement (CMA). RBI clearly advised the banks that there is no change in the prescribed criteria for lending to the borrowers to meet their working capital requirement to meet their long-term credit requirements.

6.6. In text Questions

1) Critically analyse recent monetary policy in India

Monetary Policy-Meaning

Monetary policy is the process by which monetary authority of a country, generally a central bank controls the supply of money in the economy by exercising its control over interest rates in order to maintain price stability and achieve high economic growth. In India, the central monetary authority is the Reserve Bank of India (RBI). It is so designed as to maintain the price stability in the economy

Monetary policy can be either expansionary or contractionary. Under an expansionary policy the total supply of money are increased in the economy more rapidly than usual, and under contractionary policy the money supply expands more slowly than usual or even shrinks.

Expansionary policy is traditionally used to reduce unemployment in a recession by lowering interest rates in the hope that easy credit will encourage the entrepreneurs to begin new enterprise or expand their existing businesses. Contractionary policy is intended to slow inflation in order to avoid the resulting distortions and deterioration of asset values.

Definition

According to Prof. Harry Johnson, "A policy employing the central banks control of the supply of money as an instrument for achieving the objectives of general economic policy is a monetary policy."

According to **A.G. Hart**, "A policy which influences the public stock of money substitute of public demand for such assets of both that is policy which influences public liquidity position is known as a monetary policy." From both these definitions, it is clear that a monetary policy is related to the availability and cost of money supply in the economy in order to attain certain broad objectives. The Central Bank of a nation keeps control on the supply of money to attain the objectives of its monetary policy.

Objectives of the Monetary policy

The objectives of a monetary policy in India are similar to the objectives of its five year plans. In a nutshell planning in India aims at growth, is stability and social justice. The objectives of the monetary policy of India, as stated by RBI, are:

1. Price Stability:

It implies promoting economic development with considerable emphasis on price stability. The centre of focus is to facilitate the environment which is favorable to the architecture that enables the developmental projects to run swiftly while also maintaining reasonable price stability. All the economics suffer from inflation and deflation. It can also be called as Price Instability. Both are harmful to the economy. Thus, the monetary policy having an objective of price stability tries to keep the value of money stable. It helps in reducing the income and wealth inequalities. When the economy suffers from recession the monetary policy should be an 'easy money policy' but when there is inflationary situation there should be a 'dear money policy'.

2. Rapid Economic Growth:

It is the most important objective of a monetary policy. The monetary policy can influence economic growth by controlling real interest rate and its resultant impact on the investment. If the RBI opts for a cheap or easy credit policy by reducing interest rates, the investment level in the economy can be encouraged. This increased investment can speed up economic growth. Faster economic growth is possible if the monetary policy succeeds in maintaining income and price stability.

3. Controlled Expansion of Bank Credit

One of the important functions of RBI is the controlled expansion of bank credit and money supply with special attention to seasonal requirement for credit without affecting the output.

4. Exchange Rate Stability:

Exchange rate is the price of a home currency expressed in terms of any foreign currency. If this exchange rate is very volatile leading to frequent ups and downs in the exchange rate, the international community might lose confidence in our economy. The monetary policy aims at maintaining the relative stability in the exchange rate. The RBI by altering the foreign exchange reserves tries to influence the demand for foreign exchange and tries to maintain the exchange rate stability

5. Balance of Payments (BOP) Equilibrium:

Many developing countries like India suffer from the Disequilibrium in the BOP. The Reserve Bank of India through its monetary policy tries to maintain equilibrium in the

balance of payments. The BOP has two aspects i.e. the 'BOP Surplus' and the 'BOP Deficit'. The former reflects an excess money supply in the domestic economy, while the later stands for stringency of money. If the monetary policy succeeds in maintaining monetary equilibrium, then the BOP equilibrium can be achieved.

6. Equal Income Distribution:

Many economists used to justify the role of the fiscal policy in maintaining economic equality. However in recent years economists have given the opinion that the monetary policy can help and play a supplementary role in attaining an economic equality. Monetary policy can make special provisions for the neglect supply such as agriculture, small-scale industries, village industries, etc. and provide them with cheaper credit for longer term. This can prove fruitful for these sectors to come up. Thus in recent period, monetary policy can help in reducing economic inequalities among different sections of society.

7. Neutrality of Money:

Economist such as Wicksteed, Robertson has always considered money as a passive factor. According to them, money should play only a role of medium of exchange and not more than that. Therefore, the monetary policy should regulate the supply of money. The change in money supply creates monetary disequilibrium. Thus monetary policy has to regulate the supply of money and neutralize the effect of money expansion. However this objective of a monetary policy is always criticized on the ground that if money supply is kept constant then it would be difficult to attain price stability.

8. Full Employment:

The concept of full employment was much discussed after Keynes's publication of the "General Theory" in 1936. It refers to absence of involuntary unemployment. In simple words 'Full Employment' stands for a situation in which everybody who wants jobs get jobs. However it does not mean that there is Zero unemployment. In that senses the full employment is never full. Monetary policy can be used for achieving full employment. If the monetary policy is expansionary then credit supply can be encouraged. It could help in creating more jobs in different sector of the economy.

9. Promotion of Fixed Investment:

The aim here is to increase the productivity of investment by restraining non essential fixed investment.

10. Promotion of Exports and Food Procurement Operations

Monetary policy pays special attention in order to boost exports and facilitate the trade. It is an independent objective of monetary policy.

11. Desired Distribution of Credit

Monetary authority has control over the decisions regarding the allocation of credit to priority sector and small borrowers. This policy decides over the specified percentage of credit that is to be allocated to priority sector and small borrowers.

12. Equitable Distribution of Credit

The policy of Reserve Bank aims equitable distribution to all sectors of the economy and all social and economic class of people

13. To Promote Efficiency

It is another essential aspect where the central banks pay a lot of attention. It tries to increase the efficiency in the financial system and tries to incorporate structural changes such as deregulating interest rates, ease operational constraints in the credit delivery system, to introduce new money market instruments etc.

14. Reducing the Rigidity

RBI tries to bring about the flexibilities in the operations which provide a considerable autonomy. It encourages more competitive environment and diversification. It maintains its control over financial system whenever and wherever necessary to maintain the discipline and prudence in operations of the financial system.

Instruments of Monetary policy:

Instruments of Monetary operations involve monetary techniques which operate on monetary magnitudes such as money supply, interest rates and availability of credit aimed to maintain Price Stability, Stable exchange rate, Healthy Balance of Payment, Financial stability, Economic growth etc. RBI, the apex institute of India which monitors and regulates the monetary policy of the country stabilizes the price by controlling Inflation.RBI takes into account the following monetary policies:

The instruments of monetary policy and control can be classified into two:-I. Quantitative weapons (Indirect Instruments): Quantitative methods or weapons are those which control total volume or size of credit in the country without any reference to the purpose for which it is used. They affect indiscriminately all sections of the economy. Important quantitative weapons are:

a. Bank rate policy

b. Open market operations

c. Variable Cash Reserve Ratio (CRR)

d. Variable Statutory Liquidity Ratio (SLR)

e. Liquidity Adjustment Facility (LAF) includes Repo rate and Reverse Repo rate

f. Marginal Standing Facility (MSF)

II. Qualitative weapons (Direct Instruments): Qualitative weapons are those which regulate the quality of credit i.e., uses to which credit is put. They are concerned with the encouragement of credit to productive uses, and discouragement of credit to non essential activities. The main qualitative credit control weapons are:

a. Regulation of margin requirements

b. Regulation of consumer credit

c. Issuing of Directives

d. Rationing of credit

e. Credit authorisation scheme

f. Moral suasion

g. Direct action

The details review of the quantitative methods of monetary policy are discussed here under.

a. Bank rate policy: - Section 49 of RBI Act, 1934 defines the bank rate as "the standard rate at which the Reserve Bank is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase under the Act". Thus bank rate is the minimum rate at which the RBI is ready to rediscount eligible bills of exchange or other commercial papers presented to it by the commercial banks or grant loans to the commercial banks against approved securities. By manipulating the bank rate the RBI can control the bank credit and the general price level of the country.

By raising the bank rate, it can make the bank credit costlier and thereby cause contraction of bank credit. By lowering the bank rate, on the other hand, it can make the bank credit cheaper and thereby cause contraction of bank credit.

Though the bank rate policy of RBI has had some effects on some occasions, on a whole, it has not been very effective. The ineffectiveness of bank rate in controlling credit is due to the following factors.

- A major portion of credit requirements is met by indigenous bankers, who are not under the control of RBI.
- Lack of co-ordination between various sectors of money market: There is a wide disparity of interest rates in Indian money market.
- Market rate of interest does not change in same proportion of bank rate.
- There is scarcity of eligible bills in Indian money market and rediscounting is not so popular in India.

- Banks are left with large deposits even after meeting the minimum statutory reserves. So they did not feel the necessity of seeking financial assistance from RBI.

b. Open Market Operations(OMO): - An open market operation is an instrument of monetary policy which involves buying or selling of government securities from or to the public and banks. This mechanism influences the reserve position of the banks, yield on government securities and cost of bank credit. The RBI sells government securities to contract the flow of credit and buys government securities to increase credit flow. Open market operation makes bank rate policy effective and maintains stability in government securities market. Apart from outright purchase and sales of securities, RBI also involves in the Switch operations i.e., purchase of one type of securities against the sales of another type of securities. The main objectives of open market operations are:

Objectives of OMO

- To facilitate borrowing of funds by the govt. from the public.
- To maintain the prices of Government Securities stable. When there is a fall, RBI purchases them to raise their prices.
- To offset the seasonal changes in the supply of money in money market.
- To support the bank rate policy.
- To control credit.

c. Variable Cash Reserve Ratio (CRR): - Cash Reserve Ratio is a certain percentage of bank deposits which banks are required to keep with RBI in the form of reserves or balances .Higher the CRR with the RBI lower will be the liquidity in the system and vice-versa.RBI is empowered to vary CRR between 15 percent and 3 percent. But as per the suggestion by the Narshimham committee Report the CRR was reduced from 15% in the 1990 to 5 percent in 2002. As of October 2013, the CRR is 4.00 percent. Though the RBI was empowered to make use of the weapon of variable cash reserve ratio as early as 1951, the RBI made use of this weapon only since March,1960.

d. Variable Statutory Liquidity ratio (SLR): - The current SLR is 23%. According to sec 24 of BRA 1949, every commercial bank is required to maintain a certain percentage of its total deposits in liquid assets such as cash in hand, excess reserve with RBI, balances with other banks, gold and approved Government and other securities. This proportion of liquid assets to total deposits is called SLR. BRA empowers RBI to fix the SLR up to 40%. The variation of the SLR is intended to reduce the lendable funds in the hands of the commercial banks and to check the expansion of bank credit. An increase in SLR will

decrease the lendable funds in the hands of commercial banks and vice versa. Present rate of SLR is 23%. (as on jan'2014)

e. Liquidity Adjustment Facility (LAF) includes Repo rare and Reverse Repo: -LAF consists of daily infusion or absorption of liquidity on a repurchase basis ,through repo (liquidity injection) and reverse repo (liquidity absorption) auction operations through government securities as collateral securities.

- Repo rate is the rate at which RBI lends to commercial banks generally against government securities. Reduction in Repo rate helps the commercial banks to get money at a cheaper rate and increase in Repo rate discourages the commercial banks to get money as the rate increases and becomes expensive.
- Reverse Repo rate is the rate at which RBI borrows money from the commercial banks. The increase in the Repo rate will increase the cost of borrowing and lending of the banks which will discourage the public to borrow money and will encourage them to deposit. As the rates are high the availability of credit and demand decreases resulting to decrease in inflation. This increase in Repo Rate and Reverse Repo Rate is a symbol of tightening of the policy. As of October 2013, the repo rate is 7.75 % and reverse repo rate is 6.75%. On January 28, 2014, RBI raised repo rate by 25 basis points to 8.00 %.

f. Marginal Standing Facility: - This was instituted under which the scheduled commercial banks can borrow over night at their discretion upto one percent of their respective NDTL at 100 basis points above the repo rate to provide a safety valve against unanticipated liquidity shocks

The detailed explanations of the major qualitative methods are given here under.

a. Regulation of margin requirement: - Margin refers to the difference between loan amount and the market value of collateral placed to raise the loan. RBI fixes a lower margin to borrowers whose need is urgent. For e.g. if RBI believes that farmers should be financed urgently, RBI would direct to lower the margin requirement on agricultural commodities. RBI has used this weapon for a number of times.

b. Issuing of Directives : - Under section 21,of the BRA of 1949, RBI is empowered to issue directives to any particular bank or to the entire banking system and the banks are bound to comply with the directives issued to them. RBI directives can be in regard to:

- Purpose for which advance may or may not be made
- Margins requirement

- Maximum amount of loan that can be sanctioned to any company, firm or person.
- Rate of interest and other terms and conditions on which loans may be given

c. Credit Ceiling: - In this operation RBI issues prior information or direction that loans to the commercial banks will be given up to a certain limit. In this case commercial bank will be tight in advancing loans to the public. They will allocate loans to limited sectors. Few example of ceiling are agriculture sector advances, priority sector lending.

d. Credit Authorization Scheme: - Credit Authorization Scheme was introduced in November, 1965 when P C Bhattacharya was the chairman of RBI. Under this instrument of credit the commercial banks are required to obtain the RBI's prior authorization for sanctioning any fresh credit beyond the authorized limits.

e. Moral Suasion: - Moral Suasion is just as a request by the RBI to the commercial banks to follow a particular line of action. RBI may request commercial banks not to give loans for unproductive purpose which does not add to economic growth but increases inflation.

f. Direct Action: - This method is rarely used by RBI. But it is adopted when all other measures fail. It implies refusal of RBI to extend rediscounting facilities to banks which follows unsound banking practices and such other measures.

In text Questions

1). Enumerate the objectives of monetary policy?

2). Briefly explain the principal instruments of monetary policy.

3). Analyse the significance of monetary policy in India.

4). Explain the limitations of Monetary Policies.

5). Write an essay on monetary policy.

Lesson-7

Money Market

Structure

7.2. Money Market Meaning and Definition

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

On the basis of maturity of assets that is dealt with, financial market is divided into two categories viz., money market & capital market. Money market deals in highly liquid short term financial assets (maturity ranging between several days to one year) whereas capital market deals in long term financial instruments (say, with a maturity of more than one year) like equity shares. But money market does not refer to a particular place where money is borrowed and lent by the parties concerned. Mostly, transactions between takes place over phone or mail or through agents. No personal contact or presence of the two parties is essential.

Thus money market refers to the institutional arrangements facilitating borrowing and lending of short term funds. According to Crowther "Money Market is the collective name given to the various firms and institutions that deal in various grades of near money".

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

7.3 Functions of the Money Market

The money market performs the following functions : 1. The basic function of money market is to facilitate adjustment of liquidity position of commercial banks, business corporations and other non-bank financial institutions.

2. It provides outlets to commercial banks, business corporations, non-bank financial concerns and other investors for their short-term surplus funds.

3. It provides short-term funds to the various borrowers such as businessmen, industrialists, traders etc.

4. Money market provides short-term funds even to the government institutions.

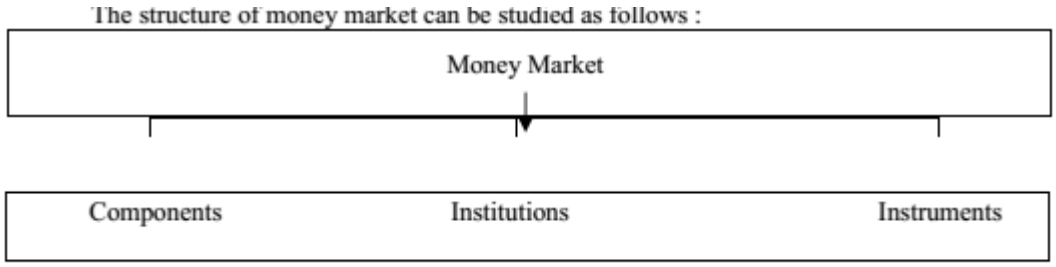
5. The money market constitutes a highly efficient mechanism for credit control. It serves as a medium through which the Central Bank of the country exercises control on the creation of credit.

6. It enables businessmen to invest their temporary surplus for a short-period.

7. It plays a vital role in the flow of funds to the most important uses.

7.4 Structure of Money Market

The structure of money market can be studied as follows :



Constituents of Indian money market

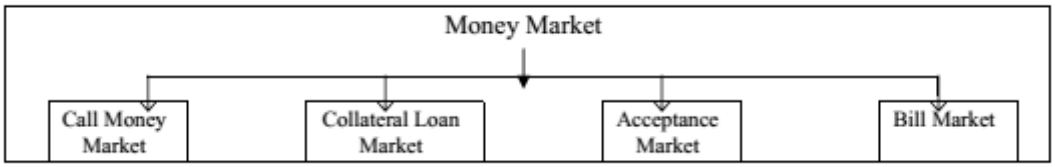
Main constituents of money market are the lenders who supply funds and borrowers who demand short term credit. Suppliers of funds may belong to either

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

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

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

Sub- markets of organized money market



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

2. Commercial bill market:

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

If the bill is payable at a future date and the seller needs money during the currency of the bill then he may approach his bank for discounting the bill. The maturity proceeds (face value of discounted bill), from the drawee, will be received by the bank.

If the bank needs fund during the currency of the bill then it can rediscount the bill already discounted by it in the commercial bill rediscount market at the market related discount rate.

The bill discounting market is not so popular in India. It barely constitute 10% of total bank credit. The establishment of Discount and Finance House of India (DFHI) in 1988 has been an important step towards the development of an active discount market in India.

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

3. Bankers acceptance

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

7.5. Treasury bill (T bill) market

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

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

7.5.1. Types of Treasury bills

In India, there are 2 types of treasury bills viz

1. Ordinary or regular

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

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

On the other hand, 'ad-hocs' are always issued in favour of the RBI only. They are not sold through tender or auction. They are purchased by the RBI and the RBI is authorised

to issue currency notes against them. They aren't marketable in India. Holders of these bills can always sell them back to the RBI.

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

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

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

3. 364-Day (1 year) T bill- maturity is in 364 days. Its auction is on every alternate Wednesdays preceding reporting Fridays.

A considerable part of the government's borrowings happen through Treasury bills of various maturities. Based on the bids received at the auctions, RBI decides the cut off yield and accepts all bids below this yield.

All entities registered in India like banks, financial institutions, Primary Dealers, firms, companies, corporate bodies, partnership firms, institutions, mutual funds, Foreign Institutional Investors, State Governments, Provident Funds, trusts, research organisations, Nepal Rashtra bank and even individuals are eligible to bid and purchase Treasury bills

These T bills which are issued at a discount can be traded in the market. The treasury bills are issued in the form of promissory note in physical form or by credit to Subsidiary General Ledger (SGL) account or Gilt account in dematerialised form.

7.5.2 Advantages of investment in Treasury bills

1. No tax deducted at source
2. Zero default risk being sovereign paper
3. Highly liquid money market instrument
4. Better returns especially in the short term
5. Transparency
6. Simplified settlement
7. High degree of tradability and active secondary market facilitates meeting unplanned fund requirements.

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

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

CDs in physical form are freely transferable by endorsement and delivery. CDs in demat form can be transferred as per the procedure applicable to other demat securities. There is no lock in period for the CDs. It can be issued to individuals, corporations, companies, trusts, funds, associations, etc. Non-Resident Indians (NRIs) may also subscribe to CDs.

The minimum issue of CD to single investor is Rs.1 lakh and additional amount in multiples of Rs.1 lakh each.

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

5. Commercial Paper Market

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

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

Funds raised through CPs do not represent fresh borrowings for the corporate issuer but merely substitute a part of the banking limits available to it. Hence a company issues CPs

mostly to save on interest costs i.e. it will issue CPs only when the CP rate is lower than the bank's lending rate.

Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs) etc. can invest in CPs. However, investment by FIIs would be within the limits set for them by Securities and Exchange Board of India (SEBI) from time-to-time.

The maximum amount a company can raise through CP is up to 75 % of its total working capital limit. Fixed Income Money Market and Derivatives Association of India (FIMMDA), may prescribe, in consultation with the RBI, any standardised procedure and documentation for operational flexibility and smooth functioning of CP market.

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

6. REPO Market

A repurchase agreement, also known as a repo, is the sale of securities together with an agreement for the seller to buy back the securities at a later date. Predominantly, repos are undertaken on overnight basis, i.e., for one day period. The repurchase price should be greater than the original sale price, the difference representing interest, sometimes called the repo rate. The party that originally buys the securities effectively acts as a lender and the original seller is acting as a borrower.

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

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

A reverse repo is the mirror image of a repo. For, in a reverse repo, securities are acquired with a simultaneous commitment to resell. Hence whether a transaction is a repo or a reverse repo is determined only in terms of who initiated the first leg of the transaction.

As part of the measures to develop the corporate debt market, RBI has permitted select entities (scheduled commercial banks excluding RRBs and LABs, Primary Dealers, all-India FIs, NBFCs, mutual funds, housing finance companies, insurance companies) to undertake repo in corporate debt securities. This is similar to repo in Government securities except that corporate debt securities are used as collateral for borrowing funds. Only listed corporate debt securities that are rated 'AA' or above by the rating agencies are eligible to be used for repo. Commercial paper, certificate of deposit, non-convertible debentures of original maturity has less than one year is not eligible for the purpose.

7. Collateralized Borrowing and Lending Obligation

CBLO is another money market instrument operated by the Clearing Corporation of India Ltd. (CCIL), for the benefit of the entities who have either no access to the interbank call money market or have restricted access in terms of ceiling on call borrowing and lending transactions. CBLO is a discounted instrument available in electronic book entry form for the maturity period ranging from one day to ninety days (up to one year as per RBI guidelines). In order to enable the market participants to borrow and lend funds, CCIL provides the Dealing System through Indian Financial Network (INFINET), a closed user group to the Members of the Negotiated Dealing System (NDS) who maintain Current account with RBI and through Internet for other entities who do not maintain Current account with RBI.

Membership to the CBLO segment is extended to entities who are RBI- NDS members, viz., Nationalized Banks, Private Banks, Foreign Banks, Co-operative Banks, Financial Institutions, Insurance Companies, Mutual Funds, Primary Dealers, etc. Associate Membership to CBLO segment is extended to entities who are not members of RBI-NDS, viz., Co-operative Banks, Mutual Funds, Insurance companies, NBFCs, Corporates, Provident/ Pension Funds, etc. By participating in the CBLO market, CCIL members can borrow or lend funds against the collateral of eligible securities. Eligible securities are Central Government securities including Treasury Bills, and such other securities as specified by CCIL from time to time. Borrowers in CBLO have to deposit the required amount of eligible securities with the CCIL based on which CCIL fixes the borrowing limits.

7.7. Difference Between Capital Market & Money Market

Money Market	Capital Market
Concerned with short term funds, for a period not exceeding one year	Concerned with long term funds for a period exceeding one year.
Meets short term requirements of govt. &working capital requirement of business concerns	Meet long term requirements of govt and fixed capital requirement of business concerns
Instruments are TBs, BoEs, CPs, CDs & govt. Bonds etc.	Instruments are shares, debentures govt. Bonds etc.
Major players are central bank and commercial banks	Major players are development banks, insurance co's, MFs etc.
Central bank and other banks are working as part of money market	Capital market is functioning through money market and it has no direct contact with central bank.
Transactions are of larger amount	Transactions are of smaller amount
Instruments do not have an active secondary market	Instruments have active secondary market.
Transactions normally takes place over phone and there is no formal place	Transactions take place at formal place.
Transactions have to be conducted without the help of brokers	Transactions are conducted with the help of brokers.

7.8. Defects /Features of Indian money market

A well-developed money market is a necessary pre-condition for the effective implementation of monetary policy. RBI controls and regulates the money supply in the

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

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

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

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

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

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

- The lack of uniformity in drawing bills in different parts of the country,
- The large use of cash credit as the main form of borrowing from commercial banks,
- Presence of Inter-call money market and

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

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

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

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

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

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

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

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

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

7.9. Importance of Money Market

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

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

Financing trade: An outward and a well-knit money market system play an important role in financing the domestic as well as international trade. The traders can get short term finance from banks by discounting bills of exchange. The acceptance houses and discount market help in financing foreign trade.

Profitable investment: The money market helps the commercial banks to earn profit by investing their surplus funds in the purchase of Treasury bills and bills of exchange, these short term credit instruments are not only safe but also highly liquid. The banks can easily convert them into cash at a short notice.

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

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

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

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

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

7.10. Components of the Money Market

The money market operates through various institutions

1. Central bank/RBI
2. Commercial Banks
3. Non-Banking Financial Intermediaries
4. Discount Houses

5. Acceptance Houses

7. 11 In text Questions

1) Define Capital market
2) Define Money market
3) Short note on REPO Market
4) State the important Functions of the Money Market
5) Distinguish between Money market and Capital market.
6) What are the features of money market?
7) Discuss the components of Money market.
8) Explain the importance of money market.
9) Examine the Features of Indian money market
10) Explain advantages of investment in Treasury Bills

Lesson-8

Role of RBI and Commercial Banks in India

Structure

8.9 In text Questions

8.1 Introduction

The lesson clearly discusses the role and important functions of Central bank and Commercial banks. Further, it also discusses the contributions of both central and commercial banks in an economy.

Objectives

After studying this lesson you would be able to:

- Define the term 'banks' and examine its characteristics, importance of banks, various types of banks, the role of Central bank in an economy and its important functions.
- The text describes the role of commercial banks and its important functions.
- To analyses the importance of credit creation, etc.

Meaning and definition of 'Bank'

The term 'Bank' is derived from the Italian word 'banca', Latin word 'bancus' and French word 'banque' which means bench. In fact, Medieval European bankers transacted banking activities displaying coins on a bench.

Another view is that 'bank' might be originated from German word 'banc' which means joint stock fund.

Definitions

Definition of bank varies from countries to countries. Under English common law, a banker is defined as a person who carries on the business of banking, which is specified as conducting current accounts for his customers, paying cheques drawn on him/her, and collecting cheques for his/her customers.

According to H. L. Hart, a banker is "*one who in the ordinary course of his business honours cheques drawn upon him by person from and for whom he receives money on current accounts".*

Banking Regulation Act of 1949 defines banking as "accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise".

8.2 Characteristics of Banker/Banking

1. Banker deals with others' money
2. Banks repay deposits either on demand or after the expiry of specified period
3. They utilise deposits for lending/investment

4. They perform subsidiary services and innovative functions

5. Banking should be dominant part of business of bank

6. A bank should hold itself out as a bank

8.3 Importance of Banks

Bankers play very important role in the economic development of the nation. The health of the economy is closely related to the growth and soundness of its banking system. Although banks create no new wealth but their fund collection, lending and related activities facilitate the process of production, distribution, exchange and consumption of wealth. In this way, they become very effective partners in the process of economic development.

1. Banks mobilise small, scattered and idle savings of the people, and make them available for productive purposes

2. By offering attractive interests, Banks promote the habit of thrift and savings

3. By accepting savings, Banks provide safety and security to the surplus money

4. Banks provide convenient and economical means of payments

5. Banks provide convenient and economical means of transfer of funds

6. Banks facilitate the movement of funds from unused regions to useful regions

7. Banking helps trade, commerce, industry and agriculture by meeting their financial requirements

8. Banking connects saving people and investing people.

9. Through their control over the supply of money, Banks influence the economic activities, employment, income level and price level in the economy.

8.4. Types of Banks

Functional classification

1. Commercial banks/Deposit banks

Banks accept deposits from public and lend them mainly for commercial purposes for comparatively shorter periods are called Commercial Banks. They provide services to the general public, organisations and to the corporate community. They are oldest banking institution in the organised sector. Commercial banks make their profits by taking small, short-term, relatively liquid deposits and transforming these into larger, longer maturity loans. This process of asset transformation generates net income for the commercial bank. Many commercial banks do investment banking business although the latter is not considered the main business area. The commercial banking system consists of scheduled banks (registered in the second schedule of RBI) and non scheduled banks. Features of Commercial banks are;

They accept deposits on various accounts.

- Lend funds to organisations, trade, commerce, industry, small business, agriculture etc by way of loans, overdrafts and cash credits.
- They are the manufacturers of money.
- The perform many subsidiary services to the customer.
- They perform many innovative services to the customers.

2. Industrial banks/Investment banks

Industrial banks are those banks which provide fixed capital to industries. They are also called investment banks, as they invest their funds in subscribing to the shares and debentures of industrial concerns. They are seen in countries like US, Canada, Japan, Finland, and Germany. In India industrial banks are not found. Instead, special industrial finance corporations like IFC and SFC have been set up to cater to the needs of industries. Features of Industrial Banks are:

- Participate in management.
- Advise industries in making right investment
- Advise govt. on matters relating to industries

3. Agricultural banks

Agricultural banks are banks which provide finance to agriculture and allied sectors. It is found in almost all the countries. They are organised generally on co -operative basis. In India, Cooperative banks are registered under the Co-operative Societies Act, 1912. They generally give credit facilities to small farmers, salaried employees, small-scale industries, etc. Co-operative Banks are available in rural as well as in urban areas. Agricultural banks are of two types;

Agricultural co-operative banks: They provide short term finance to farmers for purchasing fertilizers, pesticides and seeds and for the payment of wages.

Land Development Banks: They provide long term finance for making permanent improvement on land. They assist to purchase machinery, equipments, installation of pump sets, construction of irrigation works etc.

4. Exchange banks

Exchange banks finances foreign exchange business (export, import business) of a country.

Special exchange banks are found only in some countries. The main functions of exchange banks

are remitting money from one country to another country, discounting of foreign bills, buying and selling gold and silver, helping import and export trade etc.

5. Savings bank

Savings banks are those banks which specialise in the mobilisation of small savings of the middle and low income group. In India, saving bank activities are done by commercial banks and post offices. Features of savings banks are;

- Mobilise small and scattered savings
- Promote habit of thrift & savings
- Keep only small portion in hand and invest major part in govt. securities
- They do not lend to general public.

6. Central / National banks

It is the highest banking & monetary institution in a country. It is the leader of all other banks. Since it is occupying a central position, it's known as Central Bank. It is operating under state's control and is not a profit motive organisation. Reserve Bank of India (India), Bank of Canada (Canada), Federal Reserve System(USA) etc are the examples of Central Banks. The main functions of a Central Bank are;

- Monopoly of currency issue
- Acts as banker to the govt.
- Serves as bankers' bank
- Act as controller of credit
- Custodian of nation's gold and foreign exchange reserve.

8.5 Functions of Commercial Banks

Functions of a Commercial Bank can be classified into three.

1. Principal/ Primary/ Fundamental functions
2. Subsidiary/ Secondary/ Supplementary functions
3. Innovative functions.

Principal functions

Commercial banks perform many functions. They satisfy the financial needs of the sectors such as agriculture, industry, trade, communication, so they play very significant role in a process of economic social needs. The functions performed by banks, since recently, are becoming customer-centred and are widening their functions. Generally, the functions of commercial banks are divided into two categories; primary functions and the secondary functions. Two 'acid test' functions of commercial banks are Accepting deposits and Lending loans. These functions along with credit creation, promotion of cheque system

and investment in Government securities form basic functions of commercial banks. The secondary functions of commercial banks include agency services, general utility services and innovative services.

1. Receiving deposits

Most important function of a commercial bank is to accept deposit from those who can save but cannot profitably utilise this savings themselves. By making deposits in bank, savers can earn something in the form of interest and avoid the danger of theft. To attract savings from all sorts of customers, banks maintain different types of accounts such as current account, Savings bank account, Fixed Deposit account, Recurring deposit account and Derivative Deposit account.

Features of Current Accounts

- It is generally opened by trading & industrial concerns.
- It is opened not for profit or savings but for convenience in payments
- Introduction is necessary to open the account.
- Any number of transactions permitted in the account.
- Withdrawals are generally allowed by cheque
- Deposit is repayable on demand
- No interest is allowed but incidental charges claimed.
- Minimum balance requirement varies from bank to bank.

Features of Saving Bank (SB) accounts

- It is generally opened by middle/low income group who save a part of their income for future needs
- Introduction is necessary to open the account if cheque facility is allowed.
- There are some restrictions on number of withdrawals.
- Fair interest (less than FD) is offered on the deposits of this account.

Features of Fixed Deposit accounts

- It is generally Opened by small investors who do not want to invest money in risky industrial securities like shares.
- No introduction is necessary to open the account.
- No maximum limit for investing.
- Minimum period of investment is 15 days
- Withdrawal is allowed only after the expiry of a fixed period.
- Withdrawal is generally allowed by surrendering FD Receipt
- Higher rate of interest is offered on the deposits of this account,

Features of Recurring Deposit accounts / Cumulative Deposit account.

- This account is meant for fixed income group, who can deposit a fixed sum regularly.
- The amount is paid back along with interest after a specified period.
- High rate of interest is offered on recurring deposits.
- Passbook is the means through which deposits and withdrawals are made

2. Lending of funds

The second important function of commercial banks is to advance loans to its customers. Banks charge interest from the borrowers and this is the main source of their income. Modern banks give mostly secured loans for productive purposes. In other words, at the time of advancing loans, they demand proper security or collateral. Generally, the value of security or collateral is equal to the amount of loan. This is done mainly with a view to recover the loan money by selling the security in the event of non-refund of the loan.

Commercial banks lend money to the needy people in the form of Cash credits, Term loans, Overdrafts (OD), Discounting of bills, Money at call or short notice etc.

(i) Cash Credit: In this type of credit scheme, banks advance loans to its customers on the basis of bonds, inventories and other approved securities. Under this scheme, banks enter into an agreement with its customers to which money can be withdrawn many times during a year. Under this set up banks open accounts of their customers and deposit the loan money. With this type of loan, credit is created.

(ii) Term loans: A term loan is a monetary loan that is repaid in regular payments over a set period of time. In other words, a loan from a bank for a specific amount that has a specified repayment schedule and a floating interest rate is called Term loan. Term loans usually last between one and ten years, but may last as long as 30 years in some cases. It may be classified as short term, medium term and long term loans.

(iii) Over-Drafts: It is the extension of credit from a bank when the account balance reaches zero level. Banks advance loans to its customer's up to a certain amount through over-drafts, if there are no deposits in the current account. For this, banks demand a security from the customers and charge very high rate of interest. Overdraft facility will be allowed only for current account holders.

(iv) Discounting of Bills of Exchange: This is the most prevalent and important method of advancing loans to the traders for short-term purposes. Under this system, banks advance loans to the traders and business firms by discounting their bills. While discounting a bill, the Bank buys the bill (i.e. Bill of Exchange or Promissory Note) before it is due and credits the value of the bill after a discount charge to the customer's account. The transaction

is practically an advance against the security of the bill and the discount represents the interest on the advance from the date of purchase of the bill until it is due for payment. In this way, businessmen get loans on the basis of their bills of exchange before the time of their maturity.

(v) Money at Call and Short notice: Money at call and short notice is a very short-term loan that does not have a set repayment schedule, but is payable immediately and in full upon demand. Money-at-call loans give banks a way to earn interest while retaining liquidity. These are generally lent to other institutions such as discount houses, money brokers, the stock exchange, bullion brokers, corporate customers, and increasingly to other banks. 'At call' means the money is repayable on demand whereas ' At short notice' implies the money is to be repayable on a short notice up to 14 days.

3. Investment of funds in securities

Banks invest a considerable amount of their funds in government and industrial securities. In India, commercial banks are required by statute to invest a good portion of their funds in government and other approved securities. The banks invest their funds in three types of securities—Government securities, other approved securities and other securities. Government securities include both, central and state governments, such as treasury bills, national savings certificate etc. Other securities include securities of state associated bodies like electricity boards, housing boards, debentures of Land Development Banks, units of UTI, shares of Regional Rural banks etc.

4. Credit Creation

When a bank advances a loan, it does not lend cash but opens an account in the borrower's name and credits the amount of loan to this account. Thus a loan creates an equal amount of deposit. Creation of such deposit is called credit creation. Banks have the ability to create credit many times more than their actual deposit.

5. Promoting Cheque system

Banks also render a very useful medium of exchange in the form of cheques. Through a cheque, the depositor directs the banker to make payment to the payee. In the modern business transactions by cheques have become much more convenient method of settling debts than the use of cash. Through promoting cheque system, the banks ensure the exchange of accounted cash. At present, CTS (Cheque Truncation System) cheques are used by Indian Banks to ensure speedy settlement of transactions in between banks. In contrast to the declining importance of cheques, the use of electronic payment instruments at the retail level has been growing rapidly.

Subsidiary functions

1. Agency services : Banks act as an agent on behalf of the individual or organisations. Banks, as an agent can work for people, businesses, and other banks, providing a variety of services depending on the nature of the agreement they make with their clients. Following are the important agency services provided by commercial banks in India.

- Commercial Banks collect cheques, drafts, Bill of Exchange, interest and dividend on securities, rents etc. on behalf of customers and credit the proceeds to the customer's account.
- Pay LIC premium, rent, newspaper bills, telephone bills etc
- Buying and selling of securities
- Advise on right type of investment
- Act as trustees (undertake management of money and property), executors (carry out the wishes of deceased customers according to will) & attorneys (collect interest & dividend and issue valid receipt) of their customers.
- Serve as correspondents and representatives of their customers. In this capacity, banks prepare I-Tax returns of their customers, correspond with IT authorities and pay IT of their customers.

2. General Utility Services: In addition to agency services, modern banks perform many general utility services for the community. Following are the important general utility services offered by Commercial Banks

- Locker facility: Bank provides locker facility to their customers. The customers can keep their valuables such as gold, silver, important documents, securities etc. in these lockers for safe custody.
- Issue travelers' cheques: Banks issue traveler's cheques to help their customers to travel without the fear of theft or loss of money. It enables tourists to get fund in all places they visit without carrying actual cash with them.
- Issue Letter of Credits: Banks issue letter of credit for importers certifying their credit worthiness. It is a letter issued by importer's banker in favour of exporter informing him that issuing banker undertakes to accept the bills drawn in respect of exports made to the importer specified therein.
- Act as referee: Banks act as referees and supply information about the financial standing of their customers on enquiries made by other businessmen.
- Collect information: Banks collect information about other businessmen through the fellow bankers and supply information to their customers.

- Collection of statistics: Banks collect statistics for giving important information about industry, trade and commerce, money and banking. They also publish journals and bulletins containing research articles on economic and financial matters.
- Underwriting securities: Banks underwrite securities issued by government, public or private bodies.
- Merchant banking: Some bank provides merchant banking services such as capital to companies, advice on corporate matters, underwriting etc.

Innovative Functions

The adoption of Information and Communication technology enable banks to provide many

innovative services to the customers such as;

1. ATM services

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

2. Debit card and credit card facility

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

3. Tele-banking:

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

4. Internet Banking:

Online banking (or Internet banking or E-banking) is a facility that allows customers of a financial institution to conduct financial transactions on a secured website operated by the institution. To access a financial institution's online banking facility, a customer must register with the institution for the service, and set up some password for customer

verification. Online banking can be used to check balances, transfer money, shop onlline, pay bills etc.

5. Bancassurance:

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

6. Mobile Banking:

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

7. Electronic Clearing Services:

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

8. Electronic Fund Transfer/National Electronic Fund Transfer (NEFT):

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

9. Real Time Gross Settlement System(RTGS):

It can be defined as the continuous (real-time) settlement of funds transfers individually on an order by order basis . 'Real Time' means the processing of instructions at the time

they are received rather than at some later time. It is the fastest possible money transfer system in the country.

NEFT	RTGS
• Based on Deferred Net Settlement(DNS) • Fastest method of money transfer • Complete transactions in batches • There is no minimum limit of transactions. • Settlement on hour basis. (11 settlements from 9am to 7pm)	• Based on Gross Settlement • Slower than RTGS transfer • Complete transactions individually • Minimum amount to be remitted is 2 lakhs • Settlement in real time (at the time the transfer order is processed)

8. 5. Role of Commercial Banks in a Developing Economy

A well developed banking system is necessary pre-condition for economic development of any economy. Apart from providing resources for growth of industrialisation, banks also influence direction in which these resources are utilised.

In underdeveloped and developing nations banking facilities are limited to few developed cities and their activities are focussed on trade & commerce paying little attention to industry & agriculture.

Commercial banks contribute to a country's economic development in the following ways.

1. Capital formation

Most important determinant of economic development is capital formation. It has 3 distinctive stages

- Generation of savings
- Mobilisation of savings
- Canalisation of saving

Banks promote capital formation in all these stages. They promote habit of savings by offering attractive rate of return for savers. Banks are maintaining different types of accounts to mobilise savings aiming different types of customers. They make widespread arrangements to collect savings by opening branches even in remote villages. Moreover, banks offer their resources for productive activities only.

2. Encouragement to entrepreneurial innovations

Entrepreneurs in developing economies, generally hesitate to invest & undertake innovations due to lack of fund. Bank loan facilities enable them to introduce innovative ideas and increase productive capacity of the economy.

3. Monetisation of economy

Monetisation means allow money to play an active role in the economy. Banks, which are creators and distributors of money, help the monetisation in two ways;

- They monetise debt i.e., buy debts (securities) which are not as acceptable as money and convert them to demand deposits which are acceptable as money.
- By spreading branches in rural areas they convert non-monetised sectors of the economy to monetised sectors.

4. Influencing economic activity

They can directly influence the economic activity & pace of economic development through its influence on

(a) The rate of interest (reduction in rates make investment more profitable and stimulates economic activity)

(b) Availability of credit. (Through Credit creation banks helps in increasing supply of purchasing power)

5. Implementation of monetary policy

Well developed banking system is necessary for effective implementation of monetary policy. Control and regulation of credit is not possible without active co-operation of banks.

6. Promotion of trade and industry.

Economic progress of industrialised countries in last 2 centuries is mainly due to expansion in trade & industrialisation which could not have been made possible without development of a good banking system. Use of cheques, drafts and BoE as a medium of exchange has revolutionalised the internal and international trade which in turn accelerated the pace of industrialisation.

7. Encouraging right type of industries

In a planned economy it is necessary that banks should formulate their loan policies in accordance with the broad objectives and strategy of industrialisation as adopted in the plan.

8. Regional development

Banks can play role in achieving balanced development in different regions of the economy. They can transfer surplus funds from developed region to less developed regions, where there is shortage of funds.

9. Development of agricultural & other neglected sectors

Under developed economies primarily agricultural economies and majority of the population live in rural areas. So far banks were paying more attention to trade and commerce and have almost neglected agriculture and industry. Banks must diversify their activities not only to extend credit to trade, but also to provide medium and long term loans to industry and agriculture.

8.6 Credit Creation

('Loans create deposits' and 'deposits create loans')

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

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

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

Imagine that the CRR maintained by the bank is 20%. Now, Mr. A deposits Rs.10,000 with Federal Bank. The bank need not keep the entire cash in reserve to meet its day to day demand for cash. After keeping a 20% (Rs.2,000) in hand, bank extends a credit of Rs.8,000 (initial excess) to Mr. B by opening a credit account in his name. This creates another derivative deposit of Rs.8,000 in the bank. By keeping 20% (Rs.1,600) of this in hand bank again advances Rs.6,400 to Mr.C and he deposits the same in his bank, SBT. This creates a primary deposit to SBT, and it extend a credit of Rs.5120 to Mr.D after keeping 1,280 (20%) in the bank. This process continues until the initial primary deposit of Rs.10,000 with Federal Bank lead to the creation of total deposits (both primary and derivative) of Rs.50,000 or initial excess reserve of Rs. 8,000 creates a total derivative deposit of Rs.40,000 (8,000+6,400+5120+4096+……. = 40,000)

From the above illustration, it is clear that the initial primary deposit of Rs.10,000 in Federal Bank leads to the expansion of total deposit of Rs. 50,000. Initial excess reserve of Rs.8,000 creates multiple derivative deposits of Rs. 40,000. Credit creation is 5 times (Rs.40,000) of the initial excess reserve (Rs.8,000)

Credit multiplier (5) is =

$$\frac{\text{Total derivative deposits}}{\text{Initial excess reserve}}$$

$$\frac{4000}{800}$$

Or 1/ CRR i.e., 1/20%

Destruction of credit:

Banks create credit by advancing loans. Similarly banks can destroy credit by reducing loans. Extend of destruction depends on CRR. Higher the CRR greater will be the destruction of credit.

Various ways of creating money

- by advancing loans
- by allowing Overdrafts
- by providing Cash Credits
- by discounting bill of exchange
- by purchasing securities

Limitations of credit creation

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

- Amount of Cash available with the Bank: Credit creation depends on the amount of cash available with bank. Larger the amount of cash with the banking system, greater will be the credit creation and vice versa.
- Cash Reserve Ratio: CRR is the minimum cash required to be maintained by a bank with RBI. CRR sets the limit for the creation of credit. Higher the CRR smaller will be the credit creation and vice versa.
- Leakages: The credit creation by the banks is subject to certain conditions. If there is any leakage in this process the credit creation by the banks will be limited. In credit creation, it is expected that the banks lend the entire amount of excess deposits over the minimum statutory reserve. If there is any down fall in such lending, it will affect

the creation of credit to that extent. Leakage may occur either because of unwillingness of banks to utilise their surplus funds for granting loans or unwillingness of borrower to keep whole amount of loan in the bank. Both will lead to lesser credit creation.

- Security for loans: The securities acceptable to bank places a limit on credit creation by the banks. While lending, the banks insist upon the securities from the customers. All type of assets are not acceptable to banks as securities. If borrower is not able to provide sufficient security, credit creation is not possible.
- Credit policy of banks: If banks want to create excess reserves, the credit creation will be limited to that extent.
- Monetary Policy of the Central Bank: The capacity of credit creation by banks is largely depends upon the policies followed by the Central Bank from time to time. The total supply of cash depends upon the policy of the Central Bank.

- Banking habit of the people: The banking habit of the people also sets the limit for the capacity of banks to create credit. The volume of employed population, monetary habits, etc., determines the amount of cash that the public wishes to hold. If people prefer to make transactions by using cash instead of using cheques, the banks will be left with smaller amount of cash and there will be lesser credit creation.
- Effect of Trade Cycle: The effects of trade cycles also place the limitation on the credit creation, i.e., the conditions of inflation and deflation set a limit on the creation. During the period of economic prosperity there will be greater demand for bank loans and therefore, they can create greater volume of credit. But in times of recession, there is no prosperity and the business people will hesitate to borrow.

Leaf-cannon criticism

Walter Leaf and Edwin Cannon raised serious objection against theory of credit creation. They are of the view that it is the depositor who creates credit and not the banker, because, credit creation is possible only if depositors do not take home their deposits. The banks cannot loan more than what is deposited by customers. But this criticism was rejected by Crowther both on theoretical and on practical grounds citing the empirical evidences of the UK

8.7. RESERVE BANK OF INDIA

Introduction

As per the recommendation of the Central Banking Enquiry (Hilton Young) Commission, an Act was passed in the parliament called RBI Act in 1934 and accordingly RBI started its operation in April 1935 with a share capital of Rs. 5 crores. The share capital was divided into shares of Rs. 100 each fully paid which was entirely owned by private shareholders in the beginning. On establishment it took over the function of management of currency from Govt. of India and power of credit control from the then Imperial Bank of India.

The Central Office of the Reserve Bank was initially established in Calcutta but was permanently moved to Mumbai in 1937. The Central Office is where the Governor sits and where policies are formulated. RBI was taken over by GOI in 1948 by passing the RBI (transfer of public ownership) Act 1948. It started functioning as a state owned and state controlled central bank from 1st January 1948 onwards.

The Reserve Bank of India (RBI) is now the apex financial institution of the country which is entrusted with the task of controlling, supervising, promoting, developing and planning the financial system. RBI is the queen bee of the Indian financial system which influences the commercial banks' management in more than one way. The RBI influences the management of commercial banks through its various policies, directions and regulations. Its role in banking is quite unique. In fact, the RBI performs the four basic functions of management, viz., planning, organizing, directing and controlling in laying a strong foundation for the functioning of commercial banks.

RBI possesses special status in our country. It is the authority to regulate and control monetary system of our country. It controls money market and the entire banking system of our country.

Preamble

The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as: " ..to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

Management

The Reserve Bank's affairs are governed by a central board of directors. The board is appointed by the Government of India in keeping with the Reserve Bank of India Act.The organization structure of RBI consists of a Central Board and Local Board.

Central Board: The general supervision and control of the bank's affairs is vested in the Central Board of Directors which consists of 20 member team including a Governor, 4 Deputy Governors and 15 Directors (of which 4 are from local boards, and one is a finance secretary of Central Government). All these persons are appointed or nominated by Central Govt. The chairman of the Board and its Chief Executive authority is the Governor. Governors and Deputy Governors hold office for such a period as fixed by Central Government not exceeding 5 years and are eligible for reappointment. Directors hold office for 4 years and their retirement is by rotation. As a matter of practical convenience, the Board has delegated some of its functions to a committee called the Committee of the Central Board. It meets once in a week, generally Wednesdays. There are sub committees to assist committees such as building committee and staff sub-committee.

Local Board: For each regional areas of the country viz., Western, Eastern, Northern and Southern, there is a Local Board with head quarters at Bombay, Calcutta, New Delhi and Madras. Local boards consist of 5 members each appointed by the Central Government. The functions of the local boards are to advise the central board on local matters and to represent territorial and economic interests of local cooperative and indigenous banks; advice on such matters that may generally be referred to them and perform such duties as the Central Board may delegate to them. The Central office of the RBI, located at Mumbai is divided into several specialized departments. The main departments are:

1. Issue Department: - It arranges for the issue and distribution of currency notes among the different centers of the country.
2. Banking Department: - It deals with Government transactions and maintains the cash reserves of the commercial banks.
3. Department of Banking development:- It is concerned with the development of banking facilities in the unbanked and rural areas in the country.
4. Department of Banking operations: - This department supervises and controls the working of the banking institutions in the country.
5. Non-Banking Companies Department: - It regulates the activities of non-banking financial companies existing in the country.
6. Agricultural credit Department: - This department studies the problems connected with the agricultural credit in the country.

7. Industrial finance Department: - It is concerned with the provision of finance to the industrial units in the country.

8. Exchange control Department: - The entire business of sale and purchase of foreign exchange is conducted by this department.

9. Legal Department: - The main function of this department is to give legal advices to the other departments of RBI.

10. Department of Research and Statistics: - This department is concerned with conducting research on problems relating to money, credit, finance, production etc.

Objectives of RBI

Prior to the establishment of the Reserve Bank, the Indian financial system was totally inadequate on account of the inherent weakness of the dual control of currency by the Central Government and of credit by the Imperial Bank of India.

The Preamble to the Reserve Bank of India Act, 1934 spells out the objectives of the Reserve Bank as: "to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

The important Objectives are:

1. To act as Monetary Authority: Formulates implements and monitors the monetary policy to maintain price stability and ensuring adequate flow of credit to productive sectors.

2. To Regulate and supervise the financial system of the country: It prescribes broad parameters of banking operations within which the country's banking and financial system functions. It helps to maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public.

3. To Manage the Exchange Control: Manages the Foreign Exchange Management Act, 1999 to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

4. To issue currency: Issues and exchanges or destroys currency and coins not fit for circulation to give the public adequate quantity of supplies of currency notes and coins and in good quality.

5. To undertake developmental role: RBI performs a wide range of promotional functions to support national objectives.

6. To undertake related Functions by acting as:

- Banker to the Government: performs merchant banking function for the central and the state governments; also acts as their banker.
- Banker to banks: maintains banking accounts of all scheduled banks.
- Owner and operator of the depository (SGL-Subsidiary General Ledger account) and exchange (NDS) Negotiated Dealing System is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments that will facilitate electronic submission of bids/application for government bonds.

To sum up the Objectives include:

1. To manage the monetary and credit system of the country.
2. To stabilizes internal and external value of rupee.
3. For balanced and systematic development of banking in the country.
4. For the development of organized money market in the country.
5. For facilitating proper arrangement of agriculture finance and be in successful for maintaining financial stability and credit in agricultural sector.
6. For proper arrangement of industrial finance.
7. For proper management of public debts.
8. To establish monetary relations with other countries of the world and international financial institutions.
9. For centralization of cash reserves of commercial banks.
10. To maintain balance between the demand and supply of currency.
11. To regulate the financial policy and develop banking facilities throughout the country.
12. T o remain free from political influence while making financial decisions
13. To assist the planned process of development of the Indian economy. Besides the traditional central banking functions, with the launching of the five-year plans in the country, the Reserve Bank of India has been moving ahead in performing a host of developmental and promotional functions, which are normally beyond the purview of a traditional Central Bank.

Functions of RBI

RBI performs various traditional banking function as well as promotional and developmental measures to meet the dynamic requirements of the country. Main functions of RBI can be broadly classified into three. These are

I. Monetary functions or Central banking functions

II. Supervisory functions

III. Promotional and Developmental functions.

I. Monetary functions include

A. Issue of currency notes

B. Acting as banker to the Government

C. Serving as banker of other banks

D. Controlling credit

E. Controlling foreign exchange operations

A. Issue of Currency Notes: -Under Section22 of the Reserve Bank of India Act of 1934, the Reserve Bank of India is given the monopoly of note issue. Now RBI is the sole authority for the issue of currency notes of all denominations except one rupee notes and coins in the country. One rupee notes and coins are issued by Ministry of Finance of GOI. The RBI has a separate department called the Issue Department for the issue of currency notes since 1956 system of Note Issue changed from Proportional Reserve System to minimum reserve system. Under Proportional reserve system of note issue, not less than 40% of the total volume of notes issue by the RBI was to be covered by gold coins, bullion and foreign securities. But under the Minimum reserve system of note issue, RBI is required to maintain a minimum reserve of gold or foreign securities or both against the notes issued. No maximum limit is fixed on the volume of notes. RBI maintains gold and foreign exchange reserves of Rs.200 crores of which 115 crores is in gold & balance in foreign securities,Govt. of India securities, eligible commercial bills, Pro-notes of NABARD for any loans etc.

This change from Proportional Reserve system to Minimum Reserve system is made because of two major reasons. Firstly, the planned economic development of the country called for an increased supply of money, which could not be had under the proportional reserve system. Secondly, the foreign exchange held as reserve by the Reserve bank had to be released for financing the five year plans. In short, this was to enable the expanding currency requirements of the economy.

B. Acting as Banker to government: -The Reserve bank act as a banker to the Central and State Governments. As a banker to the Government RBI acts in three capacities, viz., (a) as a banker,(b) as a financial agent, and (c) as a financial advisor

(a) As a banker: - RBI renders the following services

1. Accepts deposits from the Central and State Government.

2. Collects money on behalf of Government.

3. Makes payments on behalf of the Government, in accordance with their instructions.

4. Arranges for the transfer of funds from one place to another on behalf of the Governments

5. Makes arrangements for the supply of foreign exchange to the Central and State Governments.

6. It maintains currency chests with treasuries and other agencies in places prescribed by the Government of India. These chests are supplied with sufficient currency notes to meet the requirements for the transactions of the Government.

7. Short term advances are granted to Central and State Governments for a period not exceeding three months. These advances are granted up to a certain limit without any collateral securities.

8. In times of emergencies like war, extraordinary loans are also granted to the Governments by the RBI.

(b) As a financial agent: - The services given are

1. Acts as an agent of the Central and State Governments in the matter of floatation of loans. On account of Reserve Bank's intimate knowledge of the financial markets, it is able to obtain the best possible terms for the Government in this matter. Further by coordinating the borrowing programmers of the various Governments, it is able to minimize the adverse effects of Government borrowings on the money and securities market.

2. On behalf of Central Government RBI sells treasury bills of 90 days maturity at weekly auctions and secures short-term finance for the Central Government. Apart from that RBI also sells adhoc treasury bills of 90 day's maturity to the State Governments, Semi-Government Departments and foreign central banks on behalf of the Central Government.

3. RBI manages and keeps the accounts of the public debts of the Central and State Governments. It arranges for the payment of interest and principal amount on the public debt on the due dates.

C. Banker's Bank: -RBI acts as banker to Scheduled banks. Scheduled Banks include commercial banks, foreign exchange banks, public sector banks, state co-operative banks and the regional rural banks. As a bankers' bank it renders the following services:

1. It holds a part of the cash balances of the commercial banks:- Every commercial bank in India is required to keep with the Reserve Bank a cash balance of not less than 6% of its demand and time liabilities. This rate can be increased up to 20%. The two main purposes of maintaining cash reserve by commercial banks are as follows. Firstly to

protect the interest of the depositors, secondly to enable the Reserve Bank to accommodate the commercial banks on times of difficulties and thirdly the Reserve Bank can control the credit created by the commercial banks by varying the statutory cash reserve requirements.

2. It acts as the clearing house: - By acting as clearing house the Reserve bank helps the member banks in the settlement of the mutual indebtedness without physical transfer of cash.

3. It provides cheap remittance facilities to the commercial banks

4. It provides financial accommodation to the commercial banks: - At times of financial crisis the RBI is the lender of last resort for the commercial banks. Financial assistance is given by The Reserve bank either by rediscounting eligible bills or by granting loans against approved securities.

D. Control of Credit: -RBI undertakes the responsibility of controlling credit in order to ensure internal price stability and promote sufficient credit for the economic growth of the country. Price stability is essential for economic development. To control credit, RBI makes use of both quantitative and qualitative weapons by virtue of the powers given to it by Reserve Bank of India Act of 1934 and the Indian Banking Regulation Act of 1949. These weapons are listed below.

(a) Quantitative weapons

1. Bank Rate Policy:

Bank rate is the lending rate of central bank. It is the official minimum rate at which central bank of a country rediscounts the eligible bills of exchange of the commercial banks and other financial institutions or grants short term loans to them. By increasing bank rate, RBI can make bank credit costlier.

2. Open Market Operations:

RBI Act authorizes the RBI to engage in the purchase of securities of central and State Government and such other securities as specified by Central Govt. But by and large, its open market operations are confined to Central Government Securities and to a very limited extend to State Government Securities.

RBI uses this weapon to offset the seasonal fluctuations in money market. When there is an excessive supply of money, RBI sells the securities in the open market. In that way RBI is able to withdraw the excess money from circulation. But when there is shortage of money supply in the market, it purchases securities from the open market and as a result, more money is arrived at for circulation

3. Variable Cash Reserve Ratio:

Under the RBI Act of 1934, every scheduled and non- scheduled bank is required to maintain a fixed percentage of total time and demand liabilities as cash reserve with RBI. It is called statutory Cash Reserve Ratio (CRR). An increase in CRR reduces lending capacity of the bank and a decrease in CRR increases the lending capacity. RBI can prescribe a CRR ranging up to 15% which is at present 4% (as on Jan '2014).

4. Variable Statutory Liquidity Ratio

According to sec 24 of BRA 1949, every commercial bank is required to maintain a certain percentage of its total deposits in liquid assets such as cash in hand, excess reserve with RBI, balances with other banks, gold and approved Government and other securities. This proportion of liquid assets to total deposits is called SLR. BRA empowers RBI to fix the SLR up to 40%. The variation of the SLR is intended to reduce the lendable funds in the hands of the commercial banks and to check the expansion of bank credit. An increase in SLR will decrease the lendable funds in the hands of commercial banks and vice versa. Present rate of SLR is 23%. (as on Jan '2014).

5. Repo Rate and Reverse Repo Rate

Repo rate is the rate at which RBI lends to commercial banks generally against government securities. Reduction in Repo rate helps the commercial banks to get money at a cheaper rate and increase in Repo rate discourages the commercial banks to get money as the rate increases and becomes expensive. Reverse Repo rate is the rate at which RBI borrows money from the commercial banks. The increase in the Repo rate will increase the cost of borrowing and lending of the banks which will discourage the public to borrow money and will encourage them to deposit.

As the rates are high the availability of credit and demand decreases resulting to decrease in inflation. This increase in Repo Rate and Reverse Repo Rate is a symbol of tightening of the policy. As of October 2013, the repo rate is 7.75 % and reverse repo rate is 6.75%. On January 28, 2014,RBI raised repo rate by 25 basis points to 8.00 %.

b. Selective credit controls (Qualitative weapons)

1. Credit Ceiling

In this operation RBI issues prior information or direction that loans to the commercial banks will be given up to a certain limit. In this case commercial bank will be tight in advancing loans to the public. They will allocate loans to limited sectors. Few example of ceiling are agriculture sector advances, priority sector lending.

2. Credit Authorization Scheme

Credit Authorization Scheme was introduced in November, 1965 when P C Bhattacharya was the chairman of RBI. Under this instrument of credit the commercial banks are required to obtain the RBI's prior authorization for sanctioning any fresh credit beyond the authorized limits.

3. Moral Suasion

Moral Suasion is just as a request by the RBI to the commercial banks to follow a particular line of action. RBI may request commercial banks not to give loans for unproductive purpose which does not add to economic growth but increases inflation.

4. Regulation of margin requirements:

Margin refers to the difference between loan amount and the market value of collateral placed to raise the loan. RBI fixes a lower margin to borrowers whose need is urgent. For e.g. if RBI believes that farmers should be financed urgently, RBI would direct to lower the margin requirement on agricultural commodities. RBI has used this weapon for a number of times.

5. Issuing of directives:

BRA empowers RBI to issue directives to banks and banks are bound to comply with such directives. RBI directives may relate to:

- Purpose for which advance may or may not be made
- Margins requirement
- Maximum amount of loan that can be sanctioned to any company, firm or individual
- Rate of interest and other terms and conditions on which loans may be given

E. Control of foreign Exchange operations

One of the central banking functions of the RBI is the control of foreign exchange operations. For the control of foreign exchange business, the RBI has set up a separate department called the Exchange Control Department in September, 1939. This Department has been granted wide powers to regulate the foreign exchange business of the country. As the central bank of India, it is the responsibility of the RBI to maintain the external value of the Indian rupee stable. India being member of the IMF, the RBI is required to maintain stable exchange rates between the Indian rupee and the currencies of all other member countries of the I.M.F.

Besides maintaining stable exchange rates, RBI also acts as the custodian of the foreign exchange reserves of the country. The foreign exchange reserves of the country held by RBI includes Euro, U.S. dollars, Japanese yen etc

RBI also acts as the administrator of exchange control. It ensures that the foreign exchange reserves of the country are utilized only for approved purposes and the limited foreign exchange reserves of the country are conserved for the future.

II. Supervisory functions

RBI has been given several supervisory powers over the different banking institutions in the country. The supervisory functions relate to licensing and establishment, branch expansion, liquidity of assets, amalgamation, reconstruction and liquiditation of commercial banks and co operative banks

III. Promotional and developmental functions

RBI is also performing promotional and developmental functions. These functions includes the following

a) Provision of Agricultural Credit: - For the promotion of agricultural credit RBI has set up a separate department called the Agricultural Credit Department. It. has also set up two funds namely

– 1. The National Agricultural Credit (Long term operations) and 2. The National Agricultural credit (stabilization) fund for facilitating Long term, Medium term and Short term finance for agricultural purposes.

b) Provision for Industrial finance: - RBI has played a very significant role in the field of industrial finance by helping the setting up of a number of public sector industrial finance corporations that provide short term, medium term, and long term finance for industrial purpose. These industrial finance corporations include 1. Industrial finance Corporation of India (IFCI), 2. State Finance Corporations (SFC), Industrial Development Bank of India (IDBI), 3.Industrial Reconstruction Corporation of India (IRCI), 4. Refinance Corporation of India, and 5. Unit Trust of India (UTI).

Besides the above RBI also renders the Credit Guarantee Scheme which intends to give protection to banks against possible losses in respect of their advances to small scale industrial units.

c.) Development of Bill Market: - A bill market is a place where short term bill of 3 month duration are generally discounted or rediscounted. RBI plays a very important role in the promotion of Bill Market as a well-developed bill market is essential for the smooth functioning of the credit system.

d.) Collection and publication of statistics on financial and economic matters: - These functions of RBI are extremely useful to the Government in knowing and solving

the various economic problems. They are also of immense help to financial institutions, business and industry and for general public.

e.) Miscellaneous functions:- RBI has established training centers for staff for its own staff and other banks. Bankers' training college Mumbai, National Institute of Bank Management Mumbai, Staff Training College Madras, and College of Agricultural Banking at Pune are the institutions run by RBI.

CENTRAL BANK (RESERVE BANK OF INDIA)

The Central Bank is the leader and supreme authority of Money market. It is the main source of supply of funds to the money market. It also controls and channelise the credit facilities through methods such as open market operations, rediscounting of securities etc. it is the lender of last resort. It does not enter into direct transactions with public. It regulates money supply by changing bank rates.

8.8. COMMERCIAL BANKS

Commercial banks are the oldest banking institutions in the organised sector. They constitute the predominant segment of the banking system in India. They cater to the needs of trade, commerce, industries, agriculture, small business etc. through its wide network of branches. The commercial banks form the most important part of the money market. They make advances, grant overdraft and discount bills of exchange to the business community. They also borrow from central bank directly or indirectly.

The commercial banking system consists of scheduled banks and non-scheduled banks. Scheduled Banks are those banks which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide section 42 (6) (a) of the Act.

Scheduled Commercial Banks are grouped under following categories:

1. State Bank of India and its 5 Associates (public sector banks)
2. Nationalised Banks (20 including IDBI Bank) (public sector banks)
3. Foreign Banks (43 Numbers)
4. Regional Rural Banks (61 Numbers)
5. Other Scheduled Commercial Banks (21 numbers) (Private Sector Banks)

Functions of commercial banks

1. Principal/primary/fundamental
2. Subsidiary/secondary/supplementary

Principal functions

Two 'acid test' functions of commercial banks are

1. Accepting deposits and

2. Lending or advancing loans

These functions along with credit creation, promotion of cheque system and investment in govt. securities form basic functions of commercial banks.

1. Receiving deposits

Most important function of a bank is to accept deposit from those who can save but cannot profitably utilise this savings themselves. By making deposits in bank, savers can earn something in the form of interest and avoid the danger of theft. To attract savings from all sorts of customers, banks maintain different types of accounts.

- ✓ Current accounts
- ✓ Savings Bank accounts
- ✓ Fixed Deposit accounts
- ✓ Recurring Deposit Accounts or Cumulative Deposit Account.

2. Lending of funds by means of

- ✓ Term Loans
- ✓ Overdrafts (OD)
- ✓ Cash credit
- ✓ Discounting of bills
- ✓ Money at call or short notice

3. Investment of funds in Securities

Banks invest a considerable amount of their funds in govt. and industrial securities. In India, commercial banks are required by statute to invest a good portion of their funds in government and other approved securities.

4. Credit Creation

When a bank advances a loan, it does not lend cash but opens an account in the borrower's name and credits the amount of loan to this account. Thus a loan creates an equal amount of deposit. Creation of such deposit is called credit creation. Banks have the ability to create credit many times more than their actual deposit.

5. Promoting cheque system

Banks also render a very useful medium of exchange in the form of cheques. Through a cheque the depositor directs the banker to make payment to the payee. In the modern business transactions cheques have become much more convenient method of settling debts than the use of cash.

Subsidiary functions

1. Agency services

- ✓ Collect cheques, drafts, BoE, interest and dividend on securities, rents etc. on behalf of customers and credit the proceeds to the customer's a/c.
- ✓ Pay LIC premium, rent, newspaper bills, telephone bills etc.
- ✓ Buying and selling of securities
- ✓ Advise on right type of investment
- ✓ Act as trustees (undertake management of money and property), executors (carry out the wishes of deceased customers according to will) & attorneys (collect interest & dividend and issue valid receipt) of their customers.
- ✓ Serve as correspondents and representatives of their customers. In this capacity, banks prepare I-Tax returns of their customers, correspond with IT authorities and pay IT of their customers.

2. General utility services

- ✓ Locker facility to keep valuables.
- ✓ Issue travelers' cheques which enable tourists to get fund in all places they visit without carrying actual cash with them.
- ✓ Issue Letter of Credits for importers. It is a letter issued by importer's banker in favour of exporter informing him that issuing banker undertakes to accept the bills drawn in respect of exports made to the importer specified therein.
- ✓ Act as referees and supply information about the financial standing of their customers on enquiries made by other businessmen.
- ✓ Collect information about other businessmen through the fellow bankers and supply information to their customers.
- ✓ Collection of statistics, giving important information about industry, trade and commerce, money and banking. They also publish journals and bulletins containing research articles on economic and financial matters.
- ✓ Underwriting securities issued by government, public or private bodies.
- ✓ Deals in foreign currencies.

Role of Commercial Banks in a Developing Economy

A well-developed banking system is necessary pre-condition for economic development of any economy. Apart from providing resources for growth of industrialisation, banks also influence direction in which these resources are utilised.

In underdeveloped and developing nations banking facilities are limited to few developed cities and their activities are focussed on trade & commerce paying little attention to industry & agriculture.

Commercial banks contribute to a country's economic development in the following ways.

1.Capital formation

Most important determinant of economic development is capital formation. It has 3 distinctive stages

- Generation of savings
- Mobilisation of savings
- Canalisation of saving

Banks promote capital formation in all these stages. They promote habit of savings by offering attractive rate of return for savers. Banks are maintaining different types of accounts to mobilise savings aiming different types of customers. They make widespread arrangements to collect savings by opening branches even in remote villages. Moreover, banks offer their resources for productive activities only.

2. Encouragement to entrepreneurial innovations

Entrepreneurs in developing economies, generally hesitate to invest & undertake innovations due to lack of fund. Bank loan facilities enable them to introduce innovative ideas and increase productive capacity of the economy.

3. Monetisation of economy

Monetisation means allow money to play an active role in the economy. Banks, which are creators and distributors of money, help the monetisation in two ways;

- They monetise debt i.e., buy debts (securities) which are not as acceptable as money and convert them to demand deposits which are acceptable as money.
- By spreading branches in rural areas they convert non-monetised sectors of the economy to monetised sectors.

4. Influencing economic activity

They can directly influence the economic activity & pace of economic development through its influence on

(a) The rate of interest (reduction in rates make investment more profitable and stimulates economic activity)

(b) Availability of credit. (Through Credit creation banks helps in increasing supply of purchasing power)

5. Implementation of monetary policy

Well-developed banking system is necessary for effective implementation of monetary policy. Control and regulation of credit is not possible without active co-operation of banks.

6. Promotion of trade and industry

Economic progress of industrialised countries in last 2 centuries is mainly due to expansion in trade & industrialisation which could not have been made possible without development of a good banking system. Use of cheques, drafts and BoE as a medium of exchange has revolutionalised the internal and international trade which in turn accelerated the pace of industrialisation.

7. Encouraging right type of industries

In a planned economy it is necessary that banks should formulate their loan policies in accordance with the broad objectives and strategy of industrialisation as adopted in the plan.

8. Regional development

Banks can play role in achieving balanced development in different regions of the economy. They can transfer surplus funds from developed region to less developed regions, where there is shortage of funds.

9. Development of agricultural & other neglected sectors

Under developed economies primarily agricultural economies and majority of the population live in rural areas. So far banks were paying more attention to trade and commerce and have almost neglected agriculture and industry. Banks must diversify their activities not only to extend credit to trade, but also to provide medium and long term loans to industry and agriculture.

8.9 In text Questions

1). Elucidate the role of RBI in regulation of money supply

2). Describe the role of commercial bank in economic development

3). Explain the major functions of Commercial Banks

4). Explain the functions of Reserve Bank of India

5). Discuss the Nationalised banks in Indian economic Development

6). Describe the process of credit creation by commercial banks

7). Short note on Electronic Fund Transfer/National Electronic Fund Transfer (NEFT)

8). Give an account of characteristics and importance of Banks

Lesson-9

The Mechanism of Inflation

Structure

9.1 Introduction

In the lesson 9 you have studied some basic aspects of inflation, causes of various types of inflation. We shall also discuss how, the impacts of inflation can be measured and controlled.

Objectives

After studying this lesson you should be able to:

- Understand the meaning and definition of Inflation
- Examine the types and causes of inflation
- Describe the effects and control the inflation

What is Inflation?

Inflation is a rise in the general level of prices of goods and services in an economy over a period of time.

When the general price level rises, each unit of currency buys fewer goods and services. Therefore, inflation also reflects an erosion of purchasing power of money.

According to Crowther, “Inflation is State in which the Value of Money is falling and the Prices are rising.”

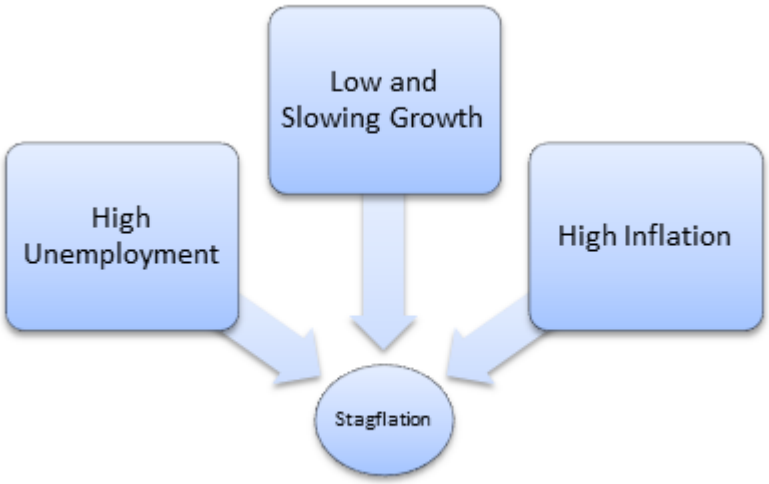
In Economics, the word ‘inflation’ refers to General rise in Prices Measured against a Standard Level of Purchasing Power.

Here are several variations on inflation used popularly to indicate specific meanings.

Deflation is when the general level of prices is falling. It is the opposite of inflation. Also referred to as Disinflation. The lack of inflation may be an indication that the economy is weakening.

Hyperinflation is unusually rapid inflation in very short span of time. In extreme cases, this can lead to the breakdown of a nation’s monetary system with complete loss of confidence in the domestic currency. One of the earlier examples of hyperinflation occurred in Germany in early 1920s after the First World War, when prices rose 2,500% in one month.

Stagflation is the combination of high unemployment with high inflation. This happened in industrialized countries during the 1970s, when a bad economy was combined with OPEC raising oil prices led to low growth. Inflation in India- economics study material and notes



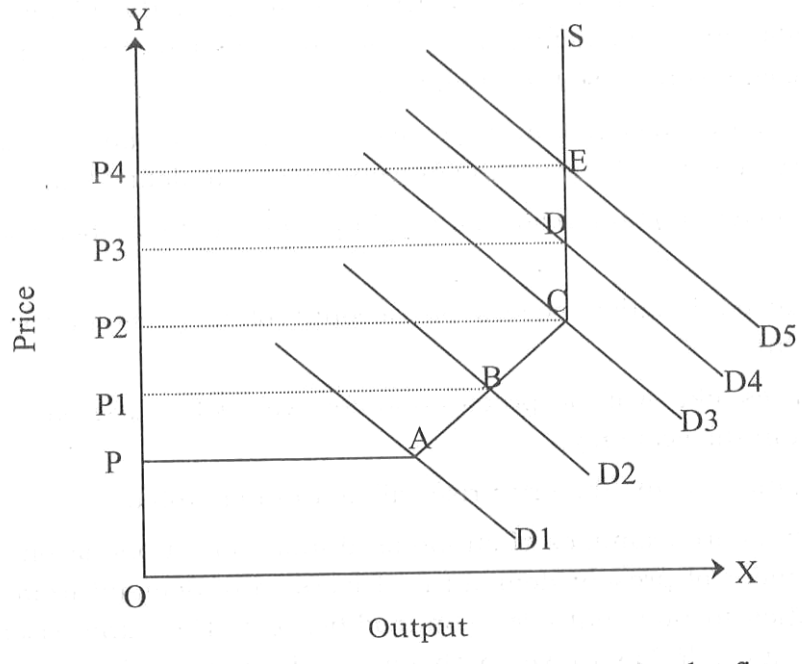
Inflation is all about prices going up, but for healthy economy wages should be rising as well. The question shouldn’t be whether inflation is rising, but whether it’s rising at a quicker pace than your wages, if the answer is a Yes only then inflation is problematic. Finally, inflation is a sign that an economy is growing. The RBI considers the range of 4-5 % as comfort zone of inflation in India.

9.2 Causes of Inflation:

There is no one cause that's universally agreed upon, but at least two theories are generally accepted while the debate still goes on:

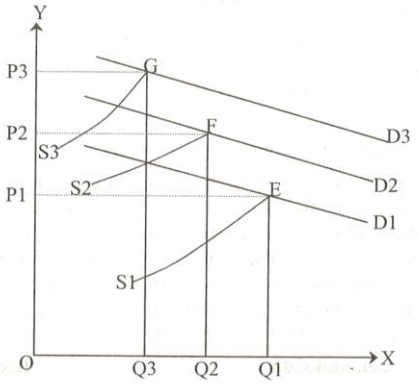
Demand-Pull Inflation – This theory can be summarized as "too much money chasing too few goods". It is a mismatch between demand and supply, if demand is growing faster than supply, prices will increase. This usually occurs in growing economies as more people gain purchasing power while the supply is not able to catch up to growing demand. When the government of a country prints money in excess, prices increase to keep up with the increase in currency, leading to inflation.

Fig (1)



Cost-Push Inflation – When production costs go up, there is an increase in prices to maintain profit margins. Increased costs can include things such as wages, taxes, or increased costs of imports.

Fig (2)



Demand pull vs Cost Push Inflation• If demand pull inflation is present in the economy, the government must bear the cost of excessive spending and monetary authorities are to be blamed for "cheap money policy"• On the contrary, if cost push is the real cause for inflation then the trade union are to blamed for excessive wage claim, industries for acceding them and business firms for marking- up profits aggressively.

Inflationary Gap

Kurihara defines inflationary gap as the "excess of anticipated expenditures over the available output at base prices. It refers to excess spending over the available goods at full employment level. Even taking for granted that there are unemployed resources in the economy which can be utilised by the excess expenditure or the excess demand, it is not possible instantaneously, due to time lag in production it will take time to build new factories, increase raw material supply and train the labourers in the technique of production. In the mean time, the increased demand, and expenditure would increase prices and inflationary gap would exist till the supply of goods is expanded.

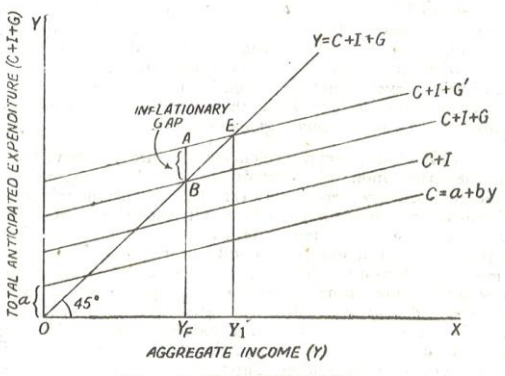


Fig. 1. The Inflationary Gap.

The above figure shows an example of inflationary gap. Total expenditure is shown by C+I+G. Suppose the total expenditure increases by AE. The new function is represented by the curve C+I+G. OY is the real income at full employment level and it does not

increase with the increase in government expenditure by AE. Thus, AE represents an excess of monetary demand over the available quantity of goods. 'AE" measures the extent of inflationary gap. Thus, inflationary gap emerges with the economy at the full employment level while the income rises faster than the output of goods and services.

9.3 Measurement of Inflation

Inflation is measured by calculating the percentage rate of change of a price index, which is called the inflation rate.

Inflation is often measured either in terms of Wholesale Price Index or in terms of Consumer Price Index.

Wholesale Price Index (WPI) : The Wholesale Price Index is an indicator designed to measure the changes in the price levels of commodities that flow into the wholesale trade intermediaries. The index is a vital guide in economic analysis and p -inflation in India-economics study material and notesolicy formulation. It is a basis for price adjustments in business contracts and projects. It is also intended to serve as an additional source of information for comparisons on the international front.

Consumer Price Index (CPI): Consumer price index is specific to particular group in the population. It shows the cost of living of the group. It is based on the changes in the retail prices of goods or services. Based on their incomes, consumer spends money on these particular set of goods and services. There are different consumer price indices. Each index tracks the changes in the retail prices for different set of consumers.

9.4 Impact or Effect of Inflation:

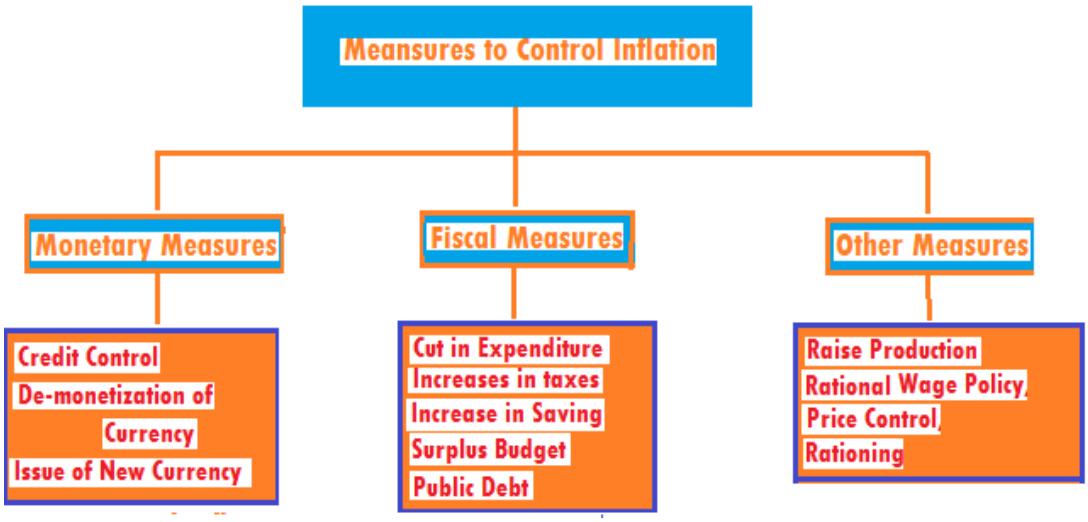
- Inflation affects the pattern of production; a shift in production pattern takes place from consumer goods to luxury goods.
- On Investment: Inflation discourages entrepreneurs in investing as the risk involved in the future production would be very high with less hope for returns. Uncertainty about the future purchasing power of money discourages investment and savings.
- Inflation also results in black marketing. Sellers may stock up the goods to be sold in the future, anticipating further price rise.
- The effect of inflation is felt on distribution of income and wealth and on production.
- People with fixed income group are the worst sufferers of inflation. Those living off a fixed-income, such as retirees, see a decline in their purchasing power and, consequently, their standard of living.

- The entire economy must absorb reprising costs ("menu costs") as price lists, labels, menus and more have to be updated.
- If the inflation rate is greater than that of other countries, domestic products become less competitive.
- They add inefficiencies in the market, and make it difficult for companies to budget or plan long-term.
- On Exchange rate and trade: There can also be negative impacts to trade from an increased instability in currency exchange prices caused by unpredictable inflation.
- On Taxes: Higher income tax rates on taxpayers. Government incurs high fiscal deficit due to decreased value of tax collections.
- On Export and balance of trade: Inflation rate in the economy is higher than rates in other countries; this will increase imports and reduce exports, leading to a deficit in the balance of trade.

9.5 Measures to Control Inflation:

Effective policies to control inflation need to focus on the underlying causes of inflation in the economy. There are two broad ways in which governments try to control inflation. These are-

1. Fiscal measures.
2. Monetary measures



Monetary Policy: Monetary policy can control the growth of demand through an increase in interest rates and a contraction in the real money supply. For example, in the late

1980s, interest rates went up to 15% because of the excessive growth in the economy and contributed to the recession of the early 1990s.

Monetary measures of controlling the inflation can be either quantitative or qualitative. Bank rate policy, open market operations and variable reserve ratio are the quantitative measures of credit control, by which inflation can be brought down. Qualitative control measures involve selective credit control measures.

Bank rate policy is used as the main instrument of monetary control during theperiod of inflation. When the central bank raises the bank rate, it is said to haveadopted a dear money policy. The increase in bank rate increases the cost ofborrowing which reduces commercial banks borrowing from the central bank.Consequently, the flow of money from the commercial banks to the public getsreduced. Therefore, inflation is controlled to the extent it is caused by the bankcredit.

Cash Reserve Ratio (CRR): To control inflation, the central bank raises the CRR which reduces the lending capacity of the commercial banks. Consequently, flow of money from commercial banks to public decreases. In the process, it halts the rise in prices to the extent it is caused by banks credits to the public.

Open Market Operations: Open market operations refer to sale and purchaseof government securities and bonds by the central bank. To control inflation,central bank sells the government securities to the public through the banks.This results in transfer of a part of bank deposits to central bank account andreduces credit creation capacity of the commercial banks.

Fiscal Policy:

- Higher direct taxes (causing a fall in disposable income).
- Lower Government spending.
- A reduction in the amount the government sector borrows each year .
- Direct wage controls – incomes policies Incomes policies (or direct wage controls) set limits on the rate of growth of wages and have the potential to reduce cost inflation.
- Government can curb it’s expenditure to bring the inflation in control.
- The government can also take some protectionist measures (such as banning the export of essential items such as pulses, cereals and oils to support the domestic consumption, encourage imports by lowering duties on import items etc.).

9.6. Summary

From the above text you have studied clearly about the concept of inflation and types. Its discussed various causes of inflation, how to measure and control the inflation. Further, it analysed inflationary gap, effects or impact of inflation.

9.7 In text Questions

1). What is Inflation?

2). Examine the causes of inflation.

3). Discuss the important characteristics of Inflation

4). Define the term " Inflationary Gap"

5). Explain different types of Inflation

6). Examine the effects of Inflation

7). How to control inflation?

8). Explain the mechanisms of Inflation

9). How to measure the Inflation?

10). Distinguish between 'Demand-Pull Inflation' and 'Cost-Push Inflation'.

11). Discuss the economic consequences of Inflation.

Lesson-10

Deflation Mechanism

Structure

10.1 Introduction

Deflation is a decline in general price levels, often caused by a reduction in the supply of money or credit. Deflation can also be brought about by direct contractions in spending, either in the form of a reduction in government spending, personal spending or investment spending. Deflation has often had the side effect of

increasing unemployment in an economy, since the process often leads to a lower level of demand in the economy (i e) Opposite of inflation.

Objectives

After studying this lesson you would be able to:

- Describe the meaning and definition of deflation
- To understand the causes of Deflation
- To know about the effects of deflation
- To analyse how to control the deflation
- To understand about the difference between Inflation and Deflation

10.2 Deflation -Meaning and Definition

Deflation is a decrease in the general price level of goods and services. Deflation occurs when the inflation rate falls below 0% (a negative inflation rate). Inflation reduces the real value of money over time; conversely, deflation increases the real value of money – the currency of a national or regional economy. This allows one to buy more goods and services than before with the same amount of money.

Economists generally believe that deflation is a problem in a modern economy because it may increase the real value of debt, especially if the deflation was unexpected. Deflation may also aggravate recessions and lead to a deflationary spiral.

In the IS-LM model (investment and saving equilibrium – liquidity preference and money supply equilibrium model), deflation is caused by a shift in the supply and demand curve for goods and services. This in turn can be caused by an increase in supply, a fall in demand, or both.

When prices are falling, consumers have an incentive to delay purchases and consumption until prices fall further, which in turn reduces overall economic activity. When purchases are delayed, productive capacity is idled and investment falls, leading to further reductions in aggregate demand. This is the deflationary spiral. An answer to falling aggregate demand is economic stimulus to increase demand, either from the central bank, by expanding the money supply, or by the fiscal authority, by increasing public spending or decreasing or deferring taxes (see fiscal multiplier).

Deflation is also related to risk aversion. Where the risk-adjusted return on assets drops to near zero (or even negative), investors and buyers will hoard currency rather than invest it, even in the most solid of securities. This can produce a liquidity trap or it may lead to shortages that entice investments yielding more jobs and commodity production. A central

bank cannot, normally, charge negative interest for money, and even charging zero interest often produces less simulative effect than slightly higher rates of interest. In a closed economy, this is because charging zero interest also means having zero return on government securities, or even negative return on short maturities. In an open economy it creates a carry trade, and devalues the currency. A devalued currency produces higher prices for imports without necessarily stimulating exports to a like degree.

Deflation is the natural condition of economies when the supply of money is fixed, or does not grow as quickly as population and the economy. When this happens, the available amount of hard currency per person falls, in effect making money more scarce, and consequently, the purchasing power of each unit of currency increases. Deflation also occurs when improvements in production efficiency lower the overall price of goods. Competition in the marketplace often prompts those producers to apply at least some portion of these cost savings into reducing the asking price for their goods. When this happens, consumers pay less for those goods, and consequently deflation has occurred, since purchasing power has increased.

Rising productivity and reduced transportation cost created structural deflation during the acceleration productivity era from 1870–1900, but there was mild inflation for about a decade before the establishment of the Federal Reserve in 1913. There was inflation during World War I, but deflation returned again after that war and during the 1930s depression. Most nations abandoned the gold standard in the 1930s. There is less reason to expect deflation, aside from the collapse of speculative asset classes, under a fiat monetary system with low productivity growth.

In mainstream economics, deflation may be caused by a combination of the supply and demand for goods and the supply and demand for money, specifically the supply of money going down and the supply of goods going up. Historic episodes of deflation have often been associated with the supply of goods going up (due to increased productivity) without an increase in the supply of money, or (as with the Great Depression and possibly Japan in the early 1990s) the demand for goods going down combined with a decrease in the money supply. Studies of the Great Depression by Ben Bernanke have indicated that, in response to decreased demand, the Federal Reserve of the time decreased the money supply, hence contributing to deflation.

10.3 Causes of Deflation

(1). ***Demand-side causes*** are:

- Growth deflation: an enduring decrease in the real cost of goods and services as the result of technological progress, accompanied by competitive price cuts, resulting in an increase in aggregate demand.

  A structural deflation existed from the 1870s until the cycle upswing that started in 1895. The deflation was caused by the decrease in the production and distribution costs of goods. It resulted in competitive price cuts when markets were oversupplied. The mild inflation after 1895 was attributed to the increase in gold supply that had been occurring for decades. There was a sharp rise in prices during World War I, but deflation returned at the war's end. By contrast, under a fiat monetary system, there was high productivity growth from the end of World War II until the 1960s, but no deflation.

  Historically not all episodes of deflation correspond with periods of poor economic growth.

  Productivity and deflation are discussed in a 1940 study by the Brookings Institution that gives productivity by major US industries from 1919 to 1939, along with real and nominal wages. Persistent deflation was clearly understood as being the result of the enormous gains in productivity of the period. By the late 1920s, most goods were over supplied, which contributed to high unemployment during the Great Depression.[17]

  - Cash building (hoarding) deflation: attempts to save more cash by a reduction in consumption leading to a decrease in velocity of money.

(2). ***Supply-side causes*** are:

- Bank credit deflation: a decrease in the bank credit supply due to bank failures or increased perceived risk of defaults by private entities or a contraction of the money supply by the central bank.

(i). Debt deflation is a complicated phenomenon associated with the end of long-term credit cycles. It was proposed as a theory by Irving Fisher (1933) to explain the deflation of the Great Depression.

(ii). **Money supply side Deflation**

From a monetarist perspective, deflation is caused primarily by a reduction in the velocity of money and or the amount of money supply per person.

A historical analysis of money velocity and monetary base shows an inverse correlation: for a given percentage decrease in the monetary base the result is nearly equal percentage increase in money velocity. This is to be expected because monetary base (M_B), velocity of

base money (V_B), price level (P) and real output (Y) are related by definition: $M_BV_B = PY$. However, it is important to note that the monetary base is a much narrower definition of money than M_2 money supply. Additionally, the velocity of the monetary base is interest rate sensitive, the highest velocity being at the highest interest rates.

In the early history of the United States there was no national currency and an insufficient supply of coinage. Banknotes were the majority of the money in circulation. During financial crises many banks failed and their notes became worthless. Also, banknotes were discounted relative to gold and silver, the discount depending on the financial strength of the bank.

In recent years changes in the money supply have historically taken a long time to show up in the price level, with a rule of thumb lag of at least 18 months. More recently Alan Greenspan cited the time lag as taking between 12 and 13 quarters. Bonds, equities and commodities have been suggested as reservoirs for buffering changes in money supply.

(iii). Credit Deflation

In modern credit-based economies, deflation may be caused by the central bank *initiating* higher interest rates (i.e., to 'control' inflation), thereby possibly popping an asset bubble. In a credit-based economy, a slow-down or fall in lending leads to less money in circulation, with a further sharp fall in money supply as confidence reduces and velocity weakens, with a consequent sharp fall-off in demand for employment or goods. The fall in demand causes a fall in prices as a supply glut develops. This becomes a deflationary spiral when prices fall below the costs of financing production, or repaying debt levels incurred at the prior price level. Businesses, unable to make enough profit no matter how low they set prices, are then liquidated. Banks get assets which have fallen dramatically in value since their mortgage loan was made, and if they sell those assets, they further glut supply, which only exacerbates the situation. To slow or halt the deflationary spiral, banks will often withhold collecting on non-performing loans (as in Japan), and most recently America and Spain). This is often no more than a stop-gap measure, because they must then restrict credit, since they do not have money to lend, which further reduces demand, and so on.

What Causes Deflation?

Deflation can be caused by a number of factors, all of which stem from a shift in the supply-demand curve. Remember, the prices of *all* goods and services are heavily affected by a change in the supply and demand, which means that if demand drops in relation to supply, prices will have to drop accordingly. Also, a change in the supply and demand of a nation's currency plays an instrumental role in setting the prices of the country's goods and services.

Although there are many reasons why deflation may take place, the following causes seem to play the largest roles:

1. Change in Structure of Capital Markets

When many different companies are selling the same goods or services, they will typically lower their prices as a means to compete. Often, the capital structure of the economy will change and companies will have easier access to debt and equity markets, which they can use to fund new businesses or improve productivity.

There are multiple reasons why companies will have an easier time raising capital, such as declining interest rates, changing banking policies, or a change in investors' aversion to risk. However, after they have utilized this new capital to increase productivity, they are going to have to reduce their prices to reflect the increased supply of products, which can result in deflation.

2. Increased Productivity

Innovative solutions and new processes help increase efficiency, which ultimately leads to lower prices. Although some innovations only affect the productivity of certain industries, others may have a profound effect on the entire economy.

For example, after the Soviet Union collapsed in 1991, many of the countries that formed as a result struggled to get back on track. In order to make a living, many citizens were willing to work for very low prices, and as companies in the United States outsourced work to these countries, they were able to significantly reduce their operating expenses and bolster productivity. Inevitably, this increased the supply of goods and decreased their cost, which led to a period of deflation near the end of the 20th century.

3. Decrease in Currency Supply

As the currency supply decreases, prices will decrease so that people can afford goods. How can currency supplies decrease? One common reason is through central banking systems.

For instance, when the Federal Reserve was first created, it considerably contracted the money supply of the United States. In the process, this led to a severe case of deflation in 1913. Also, in many economies, spending is often completed on credit. Clearly, when creditors pull the plug on lending money, customers will spend less, forcing sellers to lower their prices to regain sales.

4. Austerity Measures

Deflation can be the result of decreased governmental, business, or consumer spending, which means government spending cuts can lead to periods of significant deflation. For

example, when Spain initiated austerity measures in 2010, preexisting deflation began to spiral out of control.

5. Deflationary Spiral

Once deflation has shown its ugly head, it can be very difficult to get the economy under control for a number of reasons. First of all, when consumers start cutting spending, business profits decrease. Unfortunately, this means that businesses have to reduce wages and cut their own purchases. In turn, this short-circuits spending in other sectors, as other businesses and wage-earners have less money to spend. As horrible as this sound, it continues to get worse and the cycle can be very difficult to break.

How is Deflation Measured?

Deflation is measured by a decrease in the Consumer Price Index. However, the CPI does not measure stock prices, which retirees use to fund purchases, and businesses use to fund growth. That means when the stock market drops, the CPI might be missing one important indicator of deflation as it's felt in people's pocketbooks.

The CPI does not include sales price of homes. Instead, it calculates the "monthly equivalent of owning a home", which it derives from rents. This is very misleading since rental prices are likely to drop when there is high vacancy, usually when interest rates are low and housing prices are rising. Conversely, when home prices are dropping due to high-interest rates, rents tend to increase. Therefore, the CPI can give a false low reading when home prices are high (and rents are low).

10.4 Effects of Deflation

In many respects a serious deflation, with deep price declines lasting for months or even years, can be more damaging to an economy than all but the worst inflations. Deflation is extremely damaging to the finance markets and financial institutions. Generally deflation reduces the capacity of those who are indebted to honor their debt service commitments, or to put it more simply, debtors are unable to pay their debts. Nominal incomes, including business receipts and wages, decline during a recession, but debts – especially mortgage debts – are fixed in nominal terms.

Deflation can be compared to a terrible winter: The damage can be intense and be experienced for many seasons afterwards. Unfortunately, some nations never fully recover from the damage caused by deflation. Hong Kong, for example, never recovered from the deflationary effects that gripped the Asian economy in 2002.

Deflation may have any of the following impacts on an economy:

1. Reduced Business Revenues

Businesses must significantly reduce the prices of their products in order to stay competitive. Obviously, as they reduce their prices, their revenues start to drop. Business revenues frequently fall and recover, but deflationary cycles tend to repeat themselves multiple times.

Unfortunately, this means businesses will need to increasingly cut their prices as the period of deflation continues. Although these businesses operate with improved production efficiency, their profit margins will eventually drop, as savings from material costs are offset by reduced revenues.

2. Wage Cutbacks and Layoffs

When revenues start to drop, companies need to find ways to reduce their expenses to meet their bottom line. They can make these cuts by reducing wages and cutting positions. Understandably, this exacerbates the cycle of inflation, as more would-be consumers have less to spend.

3. Changes in Customer spending

The relationship between deflation and consumer spending is complex and often difficult to predict. When the economy undergoes a period of deflation, customers often take advantage of the substantially lower prices. Initially, consumer spending may increase greatly; however, once businesses start looking for ways to bolster their bottom line, consumers who have lost their jobs or taken pay cuts must start reducing their spending as well. Of course, when they reduce their spending, the cycle of deflation worsens.

4. Reduced Stake in Investments

When the economy goes through a series of deflation, investors tend to view cash as one of their best possible investments. Investors will watch their money grow simply by holding onto it. Additionally, the interest rates investors earn often decrease significantly as central banks attempt to fight deflation by reducing interest rates, which in turn reduces the amount of money they have available for spending.

In the meantime, many other investments may yield a negative return or are highly volatile, since investors are scared and companies aren't posting profits. As investors pull out of stocks, the stock market inevitably drops.

5. Reduced Credit

When deflation rears its head, financial lenders quickly start to pull the plugs on many of their lending operations for a variety of reasons. First of all, as assets such as houses decline in value, customers cannot back their debt with the same collateral. In the event a borrower is

unable to make their debt obligations, the lenders will be unable to recover their full investment through foreclosures or property seizures.

Also, lenders realize the financial position of borrowers is more likely to change as employers start cutting their workforce. Central banks will try to reduce interest rates to encourage customers to borrow and spend more, but many of them will still not be eligible for loans.

10.5 Historical Examples of Deflation

Although deflation is a rare occurrence in the course of an economy, it is a phenomenon that has occurred a number of times throughout history. Among others, these are incidences in which deflation has occurred:

1. Expansion of Industrial Revolution

During the late 19th century, manufacturers took advantage of new technology that allowed them to increase their productivity. As a result, the supply of goods in the economy increased substantially, and consequently, the prices of those goods decreased. Although the increase in the level of productivity after the Industrial Revolution was a positive development for the economy, it also led to a period of deflation.

2. Great Depression

The Great Depression was the most financially trying time in American history. During this dark era in history, unemployment spiked, the stock market crashed, and consumers lost much of their savings. Also, employees in high production industries such as farming and mining were producing a great amount, but not getting paid accordingly. As a result, they had less money to spend and were unable to afford basic commodities, even in spite of how much vendors were forced to reduce prices.

3. Depression of 1920-1921

About eight years prior to the onset of the Great Depression, the United States underwent a shorter depression while recovering from the aftermath of World War I. During this time, a million members of the Armed Forces returned to civilian life, and employers hired a number of returning troops at reduced wages. The labor market was already very tight before they returned, and due to the expansion in the workforce, unions lost much of their bargaining power and were unable to demand higher wages, which resulted in reduced spending.

4. European Debt Crisis

The debt crisis in Europe is causing a number of complications for the global economy. In response to this crisis, governments have implemented austerity measures, such as cutting government assistance to needy families. However, these measures have reduced GDP

considerably. Also, the banks have contracted their credit, which has reduced the money supply within the country. As a result, Europe is undergoing massive deflation.

10.5 Control of Deflation

10.6 Distinguish Between Inflation and Deflation

10.7 Summary

In this lesson you have studied that:

(i). Deflation is a decline in general price levels, often caused by a reduction in the supply of money or credit.

(ii). Deflation can be caused by a number of factors such as demand side and supply side. In addition, **Change in Structure of Capital Markets, Increased Productivity,**

10.8 Terminal Questions

1. Explain the term 'Deflation'
2. Examine the Causes and Consequences of Deflation
3. Discuss the effects of Deflation
4. How is Deflation Measured?

Lesson-11

Phillips Curve Analysis

Structure

11.1 Introduction

Philips curve analyse if unemployment decreases, inflation will increase, and vice versa. Therefore, Philips curve analyses the inverse relation and trade off between the rate of unemployment and the rate of inflation in an economy.

Objectives

After studying this lesson you would be able to:

- Understand the Philips curve analysis on inverse relation and trade off between the rate of unemployment and the rate of inflation in an economy.
- Discusses the Philips curve demonstrates that the relationship between unemployment and inflation is predictable, inverse, and stable.

Alban William Housego "A. W." "Bill" Phillips, (18.11.1914 – 4.3.1975) was an influential New Zealand economist who spent most of his academic career as a professor of economics at the London School of Economics (LSE). His best-known contribution to economics is the Phillips curve, which he first described in 1958.

11.2 Philips Curve Analysis

Philips Curve is a historical inverse relation and trade off between the rate of unemployment and the rate of inflation in an economy. Stated simply, the lower the unemployment in an economy, the higher the rate of change in wages paid to labour in that economy.

The New Zealand-born economist A.W. Phillips, in his 1958 paper "The relationship between unemployment and the rate of change of money wages in the United Kingdom 1861-1957" published in the now quarterly journal Economica, observed an inverse relationship between money wage changes and unemployment in the British economy over the period examined. Similar patterns were found in other countries and in 1960 Paul Samuelson and Robert Solow took Phillips' work and made explicit the link between inflation and unemployment—when inflation was high, unemployment were low, and vice-versa.

It is little known that the American economist Irving Fisher pointed to this kind of Phillips curve relationship back in the 1920s. On the other hand, Phillips' original curve described the behaviour of money wages. So some believe that the Philips Curve should be called the "Fisher curve."

In the years following his 1958 paper, many economists in the advanced industrial countries believed that Phillips' results showed that there was a permanently stable relationship between inflation and unemployment. One implication of this for government policy was that governments could control unemployment and inflation within a Keynesian policy. They could tolerate a reasonably high rate of inflation as this would lead to lower unemployment – there would be a trade-off between inflation and unemployment. For example, monetary policy and/or fiscal policy (i.e., deficit spending) could be used to stimulate the economy, raising gross domestic product and lowering the unemployment rate.

Moving along the Phillips curve, this would lead to a higher inflation rate, the cost of enjoying lower unemployment rates.

To a large extent, a leftward movement along the PC describes the path of the U.S. economy during the 1960s, though this move was not a matter of deciding to achieve low unemployment as much as an unplanned side-effect of the Vietnam War. In other countries, the economic boom was more the result of conscious policies.

What is a Philips Curve?

Philips Curve is a concept in economics which A.W. Philips created. This curve demonstrates that the relationship between unemployment and inflation is predictable, inverse, and stable. Philips' theory explains that when economies enjoy growth, inflation appears alongside it. This may sound like a negative side effect, but it is not necessarily according to Philips.

The growth coupled with inflation is supposed to create a greater number of jobs and lead to lower unemployment. The idea was generally accepted until the 1970s. At that point, stagflation brought on high unemployment along with inflation. This real world empirical data has at least partially disproven the idea under these circumstances.

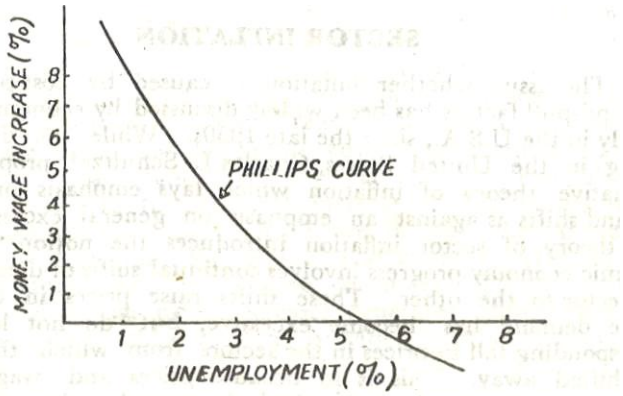


Fig. 4. Phillips Curve.

The theory that underlies Philips Curve claims that when unemployment changes in an economy, this causes a predictable impact on the inflation of prices. This relationship is said to be inversely related. On the curve, this means that the correlation between unemployment and inflation shows it as a concave (outward) and downward sloping curve. Unemployment is demonstrated on the X axis while inflation is depicted on the Y axis. It pictorially shows how inflation increasing lowers unemployment. The reverse is also shown as higher unemployment reduces inflation.

In the 1960s, economists believed that the result of fiscal stimulus would lead to a higher total demand in the economy. This would case the demand for labour to grow. The total number of workers who were unemployed would diminish, causing firms to increase

their wages to be able to competitively vie for the tinier pool of talent. Higher wages would boost costs at corporations. Companies would then choose to pass through these costs to the individual consumers. This would translate to higher prices and finally more inflation as the Philips Curve demonstrates.

Because many governments believed in these ideas, they chose to implement a so called stop-go strategy. They would affect this by establishing a target inflation rate. To attain the desired rate of inflation, they would adapt their monetary and fiscal policies as needed to contract or expand the economy. It no longer worked for them in the 1970s as the once stable and predictable model between unemployment and inflation broke down as stagflation appeared. This caused economists and governments to question the relevance and value of the Philips Curve.

Stagflation happens as economies suffer from poor economic growth at the same time as they have high inflation and more unemployment. Such a case directly contradicts the Philips Curve theories. Until the 1970s, the United States had never suffered from stagflation where such increasing levels of unemployment did not come along with reducing inflation rates.

This is because demand typically falls when economies are stagnant. It makes sense that workers who are unemployed will purchase less. This causes companies to lower their prices to encourage consumer spending. Yet from the years 1973 to 1975, the American economy managed to provide six different contiguous quarters where the GDP declined as inflation tripled. Economists now show that the 1970 occurring minor recession which policymakers aggravated with price and wage controls caused the stagflation to occur.

It was then United States President Richard Nixon who implemented such controls. His imitation of a stop-go strategy caused companies to be confused as to how to react. Because of this, they kept prices elevated more than they would have otherwise. The government no longer employs stop-go strategies since this episode of stagflation. Central banks maintain strict and rigorously enforced inflation targets now so that stagflation is less likely for the future. In the majority of economic circumstances, the Philips Curve is otherwise a true representation of the real world relationship between unemployment and inflation.

11.3 Philips Curve and its Importance:

Most economists no longer use the Phillips curve in its original form because it was shown that it simply did not work. This can be seen in a cursory analysis of US inflation and unemployment data 1953-92. There is no single curve that will fit the data, but there are three rough aggregations—1955-71, 1974-84, and 1985-92—each of which shows a general, downwards slope, but at three very different levels with the shifts occurring abruptly. The

data for 1953-54 and 1972-73 does not group easily and a more formal analysis posits up to five groups/curves over the period.

These days, however, a modified Phillips Curve is very prevalent. This new form incorporates inflationary expectations, pioneered by Edmund Phelps and Milton Friedman. This new view of the Phillips curve agrees that in the long run policy cannot affect unemployment, for it will always readjust back to its "natural rate." However, this new Phillips Curve does allow for short run fluctuations and the ability of a monetary authority such as the central bank to temporarily decrease unemployment for an increase in inflation, and vice versa.

11.4 Gordon's triangle model

Robert J. Gordon of North-western University has analysed the Phillips curve to produce what he calls the triangle model, in which the actual inflation rate is determined by the sum of demand pull or short-term Phillips curve inflation, cost push or supply shocks, and built-in inflation.

The last reflects inflationary expectations and the price/wage spiral. Supply shocks and changes in built-in inflation are the main factors shifting the short-run PC and changing the trade-off. In this theory, it is not only inflationary expectations that can cause stagflation. For example, the steep climb of oil prices during the 1970s could have this result. Changes in built-in inflation follow the partial-adjustment logic behind most theories of the NAIRU:

Low unemployment encourages high inflation, as with the simple Phillips curve. But if unemployment stays low and inflation stays high for a long time, as in the late 1960s in the U.S., both inflationary expectations and the price/wage spiral accelerate. This shifts the short-run Phillips curve upward and rightward, so that more inflation is seen at any given unemployment rate. (This is with shift B in the diagram.)

High unemployment encourages low inflation, again as with a simple Phillips curve. But if unemployment stays high and inflation stays low for a long time, as in the early 1980s in the U.S., both inflationary expectations and the price/wage spiral slow. This shifts the short-run Phillips curve downward and leftward, so that less inflation is seen at each unemployment rate.

In between these two lies the NAIRU, where the Phillips curve does not have any inherent tendency to shift, so that the inflation rate is stable. However, there seems to be a range in the middle between "high" and "low" where built-in inflation stays stable. The ends of this "non-accelerating inflation range of unemployment rates" change over time.

It's a graph of the relationship between unemployment and inflation in the economy. It's an inverse relationship of the trade off e g reduce inflation increase unemployment. Phillips curve shows the negative relationship rate of unemployment & rate of inflation in short run. Negative relationship between inflation & unemployment is known as trade off but this Negative relationship is not applicable in the long run. `

11.5 Summary

The above texts clearly discussed about the macroeconomic policies are implemented in order to achieve government's main objectives of full employment_and stable economy through low inflation. We can use Philips Curve as a tool to explain the trade-off between these two objectives. Philips Curve describes the relationship between **inflation** and **unemployment** in an economy. We understand that the Inflation is defined by increase in the average price level of goods and services over time. When there is inflation, value of money falls. A low inflation rate indicates that average price of goods would not rise as high. Unemployment exists when someone is actively seeking for job but unable to find any despite their willingness to accept the going market wage rate. Philips observed that one stable curve represents the trade-off between inflation and unemployment and they are inversely/negatively related. In other words, if unemployment decreases, inflation will increase, and vice versa.

11.6 In text Questions

1. How does Philips Curve indicate a functional relationship between the rate of wage increase and the percentage of unemployment?
2. What is stagflation? What are the causes and how can it be controlled?.
3. Discuss the economic consequences of inflation. What measures can be adopted to check inflationary pressures in an economy?
4. Is Inflation the inevitable price of rapid development or a retarding factor in economic growth?

Lesson-12

Tobin's Neo-Keynesian Model of Inflation

Structure

12.1 Introduction

The lesson discusses about Tobin's (1975) Neo-Keynesian model of deflation to the issue of inflation. As with deflation, stability of inflation depends on the strength of the Tobin- Mundell effect. The text introduces the concept of consumption and investment spending acceleration effects, which are the Keynesian analogue of increased velocity of money emphasized by monetarists. It also introduces Fisher debt effects, which increase the likelihood of instability. If the Fisher debt effect dominates the Pigou and Keynes money supply effects, inflation is unambiguously unstable. This has important policy consequences given today's high levels of indebtedness

In a seminal paper published thirty years ago, the late James Tobin (1975) developed a neo-Keynesian model of deflation. The current paper uses Tobin's model to develop a Keynesian analysis of inflation, and it shows how inflations can be unstable and degenerate into hyperinflation.

A major innovation in the paper is the inclusion of inside debt effects. This is a feature that has become of increasing policy concern to monetary authorities in many countries – including the U.S., the U.K. and Australia – because household borrowing has financed consumer spending and property booms. Debt effects are key to explaining and understanding the recent pattern of monetary policy, especially in the U.S. Thus, in the recession of 2001 the Fed determinedly lowered short-term interest rates to avoid debt-deflation effects, and then reversed itself and determinedly raised short-term interest rates to avoid debt-inflation effects.

The Tobin model is embeds a demand-pull approach to inflation. Such an approach has not been popular with Post Keynesians, who have preferred a conflict/cost- push

approach. Either – or thinking is misplaced. Both can be relevant depending on circumstances. In the 1970s and into the 1980s, when labor was stronger, a conflict/cost-push frame made sense. In today's economic environment, in which it is widely acknowledged that labor is weak, inflation is better explained in terms of demand-pull factors. This is particularly true for the United States.

In his original paper on deflation, Tobin emphasized the importance of the Tobin (1965) – Mundell (1963) effect whereby expected deflation encourages agents to hold money balances, thereby increasing money demand and real interest rates. This mechanism is also important for analysis of the inflation process. Stability again depends upon the strength of the Tobin-Mundell effect. Inflation discourages agents from holding money, which reduces money demand, lowers real interest rates, and raises aggregate demand (AD), thereby adding to inflationary pressures. The stronger the Tobin-Mundell effect, the more likely that an inflationary process will spiral into hyperinflation.

The text makes several analytical contributions. First, it shows how Tobin's model provides a simple framework for exploring the dynamics of inflation. Second, it introduces the notion of consumption and investment spending acceleration effects whereby inflation induces agents to accelerate purchases of consumption and investment goods. These acceleration effects can be viewed as the Keynesian analogue of increases in the velocity of money that have been emphasized in monetarist analyses of hyperinflation (Cagan, 1956).

Third, the text introduces inside debt into the analysis of inflation. Whereas much attention has been paid to the effect of debt in deflations (Fiaher, 1933; Caskey and Fazarri, 1987), debt appears to have been ignored in analyses of inflation (Friedman, 1968; Lucas, 1973; Sargent, 1986). Inside debt increases the likelihood that inflation is unstable and will develop into hyperinflation.

This has important policy relevance in today's highly indebted financial environment. Increases in inflation erode the value of debt burdens, thereby stimulating AD and potentially accelerating inflation. In a highly indebted environment, monetary policy therefore needs to actively supplement the automatic monetary tightening, induced by a rising price level, with a leaning against the wind interest rate policy.

12.2 The Tobin model applied to inflation

The impact of inflation on aggregate demand can be analyzed in the canonical Keynesian ISLM model given by

- + +

(1) $y = E(i-\pi^e, M/p, Z)$

- - +

(2) $M/p = L(i, \pi^e, y)$

where y = level of income, E(.) = aggregate demand function, i = nominal interest rate, π^e = expected rate of inflation, M = nominal money supply, p = price level, Z = autonomous expenditures, and L(.) = real money demand function. Signs above arguments are the assumed signs of partial derivatives.

Equation (1) is the goods market clearing condition, and has output equal to AD. AD depends negatively on the expected real interest rate, and positively on the real money supply reflecting the operation of the Pigou (1943) real balance effect. Equation (2) is the money market clearing condition, and has real money supply equal to real money demand. The demand for real money balances depends negatively on inflation reflecting the Tobin - Mundell effect. Expected inflation reduces the demand for real money balances. This is because inflation reduces the real value of money balances, thereby prompting agents to shift the composition of their portfolios away from money.

Combining equations (1) and (2) yields a general reduced form given by

- - - + + + + (3) $y = E(i(\pi^e, M/p, y) - \pi^e, M/p, Z)$

An increase in the rate of inflation raises AD and output because it reduces money demand, leading to lower real interest rates. A higher price level lowers AD and output via the Keynes real money supply and Pigou real balance effects.

The two static equilibrium conditions are supplemented by three dynamic equations of adjustment that govern the evolution of the state variables – output, inflation, and inflation expectations. The dynamic adjustment equations are given by:

+

(4.a) $g_Y = A(E - y)$ $A_1 > 0$

+

(4.b) $\pi = B(y - y^*) + \pi^e$ $B_1 > 0$

+

(4.c) $g_{\pi e} = C(\pi - \pi^e)$ $C_1 > 0$

where g_y = rate of change of output, π = actual inflation, $g_{\pi e}$ = rate of change of inflation expectations, and y^* = full employment output. Equation (4.a) is an output adjustment equation, and has output responding positively to excess demand. Equation (4.b) is a natural rate Phillips equation in which inflation is determined as a function of the output gap and inflation expectations. Equation (4.c) determines the adjustment of inflation expectations according to an adaptive principle.

The long run steady state equilibrium is given by $y = y^*$, $p = p^*$, and $\pi = \pi^e = 0$. Appropriate substitution and manipulation, combined with linearization around steady state equilibrium values, yields the following set of linearized adjustment equations:

$$\begin{matrix} & & + & + & & + & - & & + & + & \\ (5.a)\ |g_y| & = & |A_1[E_1 & - & 1] & A_1E_2 & & & A_1E_3 & | & [y - \\ & & + & + & & & & & & & \end{matrix}$$

$$\begin{matrix} & & & & & & & & & \\ (5.b)\ |\Delta p| & = & |B_1p^* & & \pi^e & & & p^* & | & [p - p^*] \\ & & + & + & & & & & & \end{matrix}$$

$$\begin{matrix} & & & & & & & & & \\ (5.c)\ |g_{\pi e}| & = & |C_1B_1 & & 0 & & 0 & & | & [\pi^e - 0] \\ & & & & & & & & & \end{matrix}$$

The condition for stability is $p^*E_2 + C_1E_3 < 0$. The term E_2 reflects the strength of the Pigou and Keynes money supply effects, while the term E_3 reflects the strength of the Tobin-Mundell effect. Stability requires that the Pigou and Keynes effects dominate the Tobin-Mundell effect.[2]

Equations (5.a) – (5.c) provide an analytical understanding of the model's stability. The stability properties of the model can also be understood through graphical analysis. Equation (3) can be represented as a set of iso-AD contours drawn in $[\pi^e, p]$ space, as is done in Figure 1. The slope of the contours is obtained by differentiating equation (3) with respect to p and π^e, yielding

$\delta p/\delta\pi^e = [E_ii_{\pi e} - E_i]/[E_ii_M/p + E_{M/p}]M/p^2] > 0$ if $E_ii_{\pi e} - E_i > 0$

The condition $E_ii_{\pi e} - E_i = E_3 > 0$ ensures that the Tobin-Mundell effect holds so that higher inflation lowers the real interest rate. The positive slope of the iso-AD contours reflects the competition between the Keynes and Pigou effects versus the Tobin –

Mundell effect. A higher price level decreases AD via the Keynes and Pigou effects, so that holding AD constant calls for a stronger Tobin-Mundell real interest rate effect operating via more rapid inflation expectations. Lower iso-contours are associated with higher levels of AD, so that $AD_1 > AD_0$. The logic is that a lower price level, holding inflation expectations unchanged, increases AD via the Keynes and Pigou effects.

Figure 2 shows a set of iso-AD contours with three different price adjustment paths. The economy is initially located on the iso-contour AD_0, which corresponds to a position of excess demand ($AD_0 > y^*$). One path has prices rising infinitely fast with no impact on inflation expectations. This path corresponds to what Tobin terms Walrasian price adjustment. The jump in the price level decreases AD, closing the output gap and the economy moves instantaneously to non-inflationary full employment. This price adjustment effect can be captured in the static ISLM model, and corresponds to the case where a higher price level shifts the IS schedule down and the LM schedule up through the Pigou real balance and Keynes money supply effects respectively.

The middle price path has prices increasing and inflation expectations rising gradually. The effect of a rising price level causes AD to fall so that the economy moves to a lower iso-AD contour. Falling AD closes the gap between AD and output, causing inflation to eventually decline and the economy again moves toward non-inflationary full employment. Along this second path the contractionary effect of a higher price level, operating via the Pigou and Keynes effects, dominates the expansionary effect of higher inflation expectations operating via the Tobin-Mundell effect. Consequently, the inflation process remains stable.

The third price path has inflation expectations rising rapidly as the price level increases. Now, the economy moves to higher iso-AD contours. Consequently, the output gap increases, moving the economy further above full employment. This is the case where inflation spirals into hyperinflation. The reason is that the Tobin-Mundell inflation expectations effect dominates the Pigou and Keynes price level effects. The economic logic behind the spiral into hyperinflation is that the jump in inflation expectations lowers money demand and real interest rates (the Tobin-Mundell effect), raising AD and increasing inflationary pressures. Though the nominal money supply is fixed, inflation can continue to accelerate because the decrease in real money demand exceeds the decrease in real money supply resulting from higher prices, thereby creating the monetary space for further inflation and a higher price level.

It should be noted that the above analysis is based on the assumption of a fixed nominal money supply – that is the monetary authority sits on its hands. This has higher prices automatically lowering the real money supply, thereby contributing to lower AD and reducing inflationary pressures. A fixed nominal money supply therefore automatically chokes off inflationary pressures and is stabilizing.

Post Keynesian theory of endogenous money emphasizes that the monetary authority really controls the nominal interest rate. In this case, assuming a fixed nominal interest rate, the nominal money supply will automatically increase to prevent nominal interest rates from rising owing to price level erosion of the real money supply. This neutralizes the Keynes money supply effect (i.e. reduces the absolute value of E_2), making it more likely that the Tobin-Mundell effect will dominate and that the inflation process is unstable and degenerates into hyperinflation. In terms of figure 2, a fixed nominal interest rate steepens the slope of the iso-AD contours, expanding the set of price adjustment paths that are unstable. This can be seen by inspection of the expression $\delta p/\delta \pi^e$, where setting the term $E_i i_{M/p}$ equal to zero makes the denominator smaller and raises the absolute value of the expression.

A third possibility is that the monetary authority follows an interest rate rule that has the nominal interest rate increase with inflation. This rule serves to increase the absolute value of E_3, making it more likely that the stability condition is met. The logic is that the interest rate rule counters the Tobin-Mundel effect. Thus, increases in inflation are expansionary via the Tobin-Mundell effect, but this expansionary effect is offset by the interest rate rule. If the interest rate rule is sufficiently vigorous, the term E_3 may become negative and the economy is unambiguously stable. The logic is higher inflation, resulting from excess demand, generates a sufficiently strong nominal interest rate response from the monetary authority that real rates and AD fall.

12.3 Consumption and investment demand acceleration effects

The above analysis has inflation expectations impacting money demand (the LM schedule), but goods demand (the IS schedule) is only impacted indirectly through the induced LM effect on the real interest rate. However, increases in the rate of inflation expectations may give agents an incentive to accelerate their consumption and investment expenditures in order to avoid higher future prices. The microeconomics of such substitutions have been explored by Neary and Stiglitz (1983) in a fix-price inter- temporal general dis-equilibrium model with rational expectations.

Consumption and investment demand acceleration effects can be readily included in the ISLM model by re-specifying the goods market clearing condition as follows

$$\underset{-}{} \quad \underset{+}{} \quad \underset{+}{} \quad \underset{+}{}$$

(1.a) $y = E(i-\pi^e, \pi^e, M/p, Z)$

The expected rate of inflation now enters as a separate argument in the AD function, with increases in the expected rate of inflation raising AD. This treatment of inflation expectations remedies a logical failing in the standard ISLM model that dichotomizes and treats as independent portfolio stock choices and spending flow decisions. Stock and flow choices are part of a unified utility maximization problem and are taken simultaneously.

This implies that arguments influencing stock demands (i.e. the demand for money) also influence flow demands (investment and consumption decisions).

The macroeconomics of expenditure acceleration effects is easily understood in terms of the familiar ISLM diagram. A jump in inflation expectations will increase investment and consumption spending and reduce saving, shifting the IS up. This expenditure acceleration effect supplements the standard Tobin-Mundell effect that shifts the LM schedule down.

With regard to the earlier mathematical stability analysis, expenditure acceleration effects change the stability properties of the model by changing the parameter E_3. After incorporating spending acceleration effects E_3 becomes $E_{ii\pi e} - E_i + E_{\pi e}$, which is larger in absolute value, therefore increasing the likelihood of instability. This proclivity to increased instability can be understood graphically using the iso-AD contour diagram. Expenditure acceleration effects steepen the slope of the iso-AD contours, which now becomes $\delta p/\delta\pi^e = [E_{ii\pi e} - E_i + E_{\pi e}]/[E_{ii}iM/p + EM/p]M/p^2] > 0$ if $E_{ii\pi e} - E_i + E_{\pi e} > 0$

The slope increases because $E_{\pi e} > 0$, which increases the value of the numerator. The economic logic of the steepening of the iso-AD contours is that increased inflation expectations now have a stronger positive impact on AD, so that maintaining a constant level of AD along an the iso-contour calls for a higher price level.

Steepening the iso-AD contours makes instability more likely as some price adjustment paths that were previously stable become unstable. The stability of the inflation process therefore depends significantly on the responsiveness of consumption and investment spending to expected inflation. The greater that responsiveness, measured by the magnitude $E_{\pi e}$, the greater the likelihood of instability.

Consumption and investment acceleration effects can be viewed as the Keynesian analogue of monetarist constructions of the impact of inflation expectations that operate through the black box of the velocity of money (Cagan, 1956: Friedman, 1956). Monetarists emphasize how inflation induces agents to reduce their demand for money, which in turn is equivalent to an increase in the velocity of circulation. From a Keynesian perspective, agents reduce their money holdings and increase their investment and consumption expenditures, with the latter being equivalent to a decrease in saving.

Monetarists analyze inflation through the Fisher equation of exchange. Increases in expected inflation raise the velocity of circulation as agents reduce their money holdings and accelerate their spending decisions to avoid the inflation tax. This is exactly the same logic as reducing money demand and accelerating consumption and investment spending decisions. In the monetarist model, these changes can lead to hyperinflation if the increase in velocity triggers a cumulative process of higher inflation that further raises velocity. This hyperinflationary monetarist outcome corresponds to an unstable price adjustment path such as is shown in Figure 2. In the current Keynesian model, increased inflation expectations drive increased spending, which raises the output gap and further raises inflation expectations.

Finally, with regard to monetary policy, such consumption and investment acceleration effects provide the rationale for the Taylor rule principle that interest rates should be adjusted slightly more than the change in inflation. Thus, if inflation accelerates, the nominal interest rate should be raised proportionately more to offset resulting consumption and investment acceleration effects.

This last point also bears on the issue of regulation that nominal interest rate ceilings, a policy known as financial repression that was once popular. Such ceilings make the model more prone to instability by increasing the parameter E_3. When inflation rises, nominal interest rate ceilings serve to hold down the real interest rate, thereby increasing AD and causing inflation to accelerate.

12.4 Inflation and inside debt effects

The above analysis ignores the presence of inside debt effects operating on debtors and creditors, the implicit assumption being that these simply wash out. Fisher (1933) analyzed the effects of deflation in the Great Depression, and argued that lower prices affected debtors and creditors asymmetrically. Lower prices increase real debt burdens of debtors while increasing the real value of debts owed to creditors by an identical amount.

However, because debtors have a higher marginal propensity to spend than creditors, this lowers AD. As a result, the Fisher debt effect can offset the positive effect of a lower price level on AD operating via the Pigou real balance and Keynes money supply effects. The net result is that a lower price level may lower AD.

Tobin (1980) and Palley (1999) have analyzed the implications of the Fisher debt effect for conditions of deflation. However, Fisher debt effects also operate in an environment of inflation and rising prices. Now, a higher price level reduces the debt service burden of debtors, positively impacting AD owing to the higher marginal propensity to spend of debtors. If the Fisher debt effect dominates the Pigou and Keynes real money supply effects, a higher price level can increase AD. This situation is captured in the ISLM diagram shown in Figure 3. Now, a higher price level shifts the LM upward (the Keynes effect), but it also shifts the IS upward as the Fisher debt effect dominates the Pigou real balance effect. If the IS shift is sufficiently strong, AD and output rise.

The incorporation of a Fisher debt effect can dramatically alter the analysis of inflation. The inclusion of inside debt changes the AD function, which is now given by

$$\underset{-}{} \quad \underset{+}{} \quad \underset{+}{} \quad \underset{-}{} \quad \underset{+}{}$$

(1.b) $y = E(i-\pi^e, \pi^e, M/p, D/p, Z)$

where D = level of nominal inside debt. The partial derivative with respect to nominal debt, E_D, is negative reflecting the Fisher debt effect. With regard to mathematical stability analysis, including Fisher debt effects changes the parameter E_2 which becomes $[E_i i_{M/p} + E_{M/p}]M + E_D D\}/p^2$. This is smaller in absolute value, making instability more likely. In terms of economic analysis, the Fisher debt effect offsets the stabilizing Pigou and Keynes effects, making instability more likely.

Once again the question of stability can be analyzed with the help of the iso-AD diagrams, and there are two cases to examine. Combining equation (1.b) with equation (2) then yields

$$\underset{-}{} \; \underset{-}{} \quad \underset{-}{} \quad \underset{+}{} \quad \underset{+}{} \quad \underset{+}{} \quad \underset{+}{} \quad \underset{-}{} \quad \underset{+}{} \quad (6)$$

$y = E(i(\pi^e, M/p, y) - \pi^e, \pi^e, M/p, D/p, Z)$

Totally differentiating with respect to π^e and p yields the slope of the iso-AD contour, which is given by

$\delta p/\delta \pi^e = [E_i i_{\pi e} - E_i + E_{\pi e}]/\{[E_i i_{M/p} + E_{M/p}]M + E_D D\}/p^{2} > 0$

where if $E_i i_{\pi e} - E_i + E_{\pi e} > 0$ and $\{[E_i i_{M/p} + E_{M/p}]M + E_D D\} < 0$.

There are two cases to be considered. The first is when the Fisher debt effect is dominated by the Pigou and Keynes effect. The second is when the Fisher effect dominates the Pigou and Keynes effects.

In case one, the Fisher debt effect is non-dominant so that $[E_i i_{M/p} + E_{M/p}]M + E_D D > 0$ and the iso-AD contour remains positively sloped. However, since $E_D D < 0$, the denominator is smaller and the absolute value of the derivative is larger, so that the slope is larger. The reason why the iso-AD contour is steeper is that higher prices have a smaller restraining impact on AD owing to the Fisher debt effect, so that any increase in inflation expectations (which increases AD) needs a larger increase in the price level to hold AD constant along the iso-contour. A steeper slope in turn means that the set of stable price adjustment paths shrinks. The inclusion of inside debt therefore renders the model more prone to instability. Moreover, the likelihood of instability depends on the level of inside debt, D, which enters in the expression for the slope of the iso-AD contour.

Case 2 is when the Fisher debt effect, $E_D D$, dominates the Pigou and Keynes effects so that $[E_i i_{M/p} + E_{M/p}]M + E_D D < 0$. In this case the slope of the iso-AD contours changes and becomes negative. In addition to reversing the slope of iso-AD contours, the Fisher debt effect also reverses their rank ordering so that higher iso-contours are associated with lower levels of AD. The logic is that a lower price level raises debt burdens and lowers AD so that a higher rate of expected inflation is needed to induce a more expansionary Tobin – Mundell effect.

Figure 4 shows the case where the Fisher debt effect dominates so that the iso-AD contours are negatively sloped. In this case, the inflation process is unambiguously unstable, with all price adjustment paths leading to higher iso-AD contours. Even if there is Walrasian-style instantaneous price adjustment with the price level rising without any impact on inflation expectations, the economy still moves to a higher iso-AD contour and the process of price adjustment remains unstable.

12.5 Policy implications

The inclusion of the Fisher debt effect has important policy implications for understanding inflation and it highlights problems posed by today's high levels of inside debt. In highly indebted environments, increases in the price level actually increase AD

through erosion of debt burdens, and this can cause the inflation process to accelerate rapidly.

Analytically, if the Fisher debt effect is non-dominant, then the region of instability is increased with its inclusion. If it is dominant, the inflation process is unambiguously unstable. Furthermore, the likelihood of instability also increases with increases in the level of inside debt, D.

The exact same reasoning applies to the deflation process (Palley, 2004). If the Fisher debt effect is dominant; the deflation process is unambiguously unstable. If it is Non-dominant, it increases size of the set of deflation price adjustment paths that are unstable.

These features mean that large debt burdens will tend to make the conduct of monetary policy more complicated and volatile. The reason is as follows. When in the deflation zone, the monetary authority must react quickly to head off the prospect of an unstable deflationary price adjustment path. But if it is successful in heading off deflation and moving to an inflationary adjustment path, monetary policy must then react quickly to head off the prospect of an unstable inflationary price adjustment path. In effect, monetary authorities may find themselves on a "knife-edge," maneuvering between an unstable deflationary path and an unstable inflationary path.

Such analysis helps explain recent U.S. Federal Reserve policy. The U.S. economy has much higher inside debt ratios than in the past, and this may signal that the economy is now prone to both unstable inflationary and unstable deflationary processes. When deflation threatened in the period 2001 – 2003, the Fed lowered interest rates much more sharply than historically warranted according to headline macroeconomic numbers in order to stave off a potentially unstable deflation. However, it was so successful that it may have triggered the possibility of an unstable inflation, and hence the need for the Fed to shift into rapid interest rate raising mode over the period 2004 - 2006.

Looking to the future, such analysis suggests that monetary policy will be more volatile owing to the new environment of high inside debt levels. The danger is, that given the knife-edge character of a highly indebted economy, there is less room for error with regard to inflation and deflation. If the monetary authority gets it wrong, either by raising rates too much or not enough, there can be rapid takeoff of deflation or inflation. Price level adjustment no longer acts as an automatic stabilizer, choking off demand under inflationary conditions and increasing demand under deflationary conditions. Instead, price level adjustment becomes an automatic de-stabilizer by either eroding debt burdens in inflationary times or augmenting them in deflationary times. In this environment

monetary authorities need to be ultra-timely in responding to both incipient inflation and incipient deflation. This is a difficult task.

12.6 Summary

From the above text you have clearly learnt that the Tobin's (1975) Neo-Keynesian model of deflation to the issue of inflation. As with deflation, stability of inflation depends on the strength of the Tobin- Mundell effect. The text discussed the concept of consumption and investment spending acceleration effects, which are the Keynesian analogue of increased velocity of money emphasized by monetarists. It also explained that the Fisher debt effects, which increase the likelihood of instability. If the Fisher debt effect dominates the Pigou and Keynes money supply effects, inflation is unambiguously unstable. This has important policy consequences given today's high levels of indebtedness.

12.7 In Text Questions

1. Explain Tobin model applied to inflation
2. Describe Tobin's Consumption and acceleration effect
3. Give the important policy consequences of inflation and inside debt effects by Tobin.

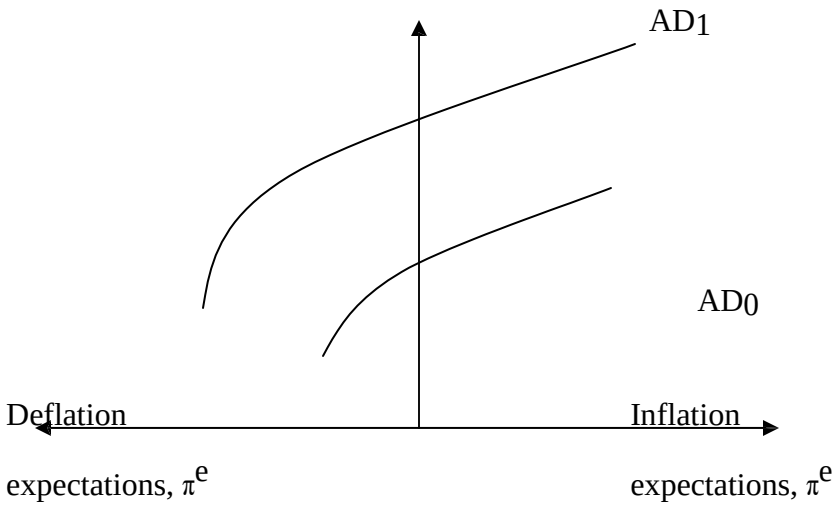


Figure 1. Iso-AD contours in which there is a positive Pigou and Keynes effect and a negative Tobin-Mundell effect. $AD_0 > AD_1$.

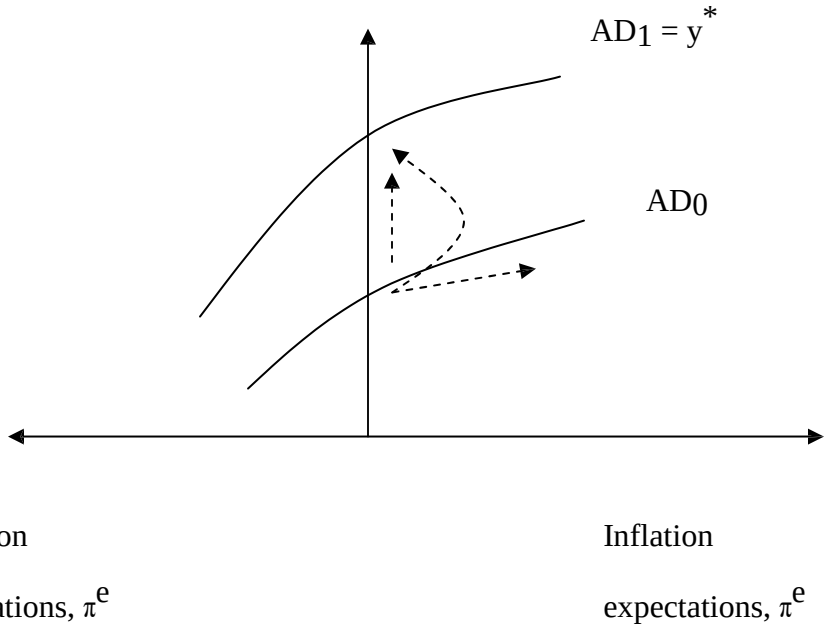


Figure 2. Three different price adjustment paths. AD decreases along the two steep paths where the price level increases with little impact on inflation expectations. AD rises along the third path. $AD_0 > AD_1$.

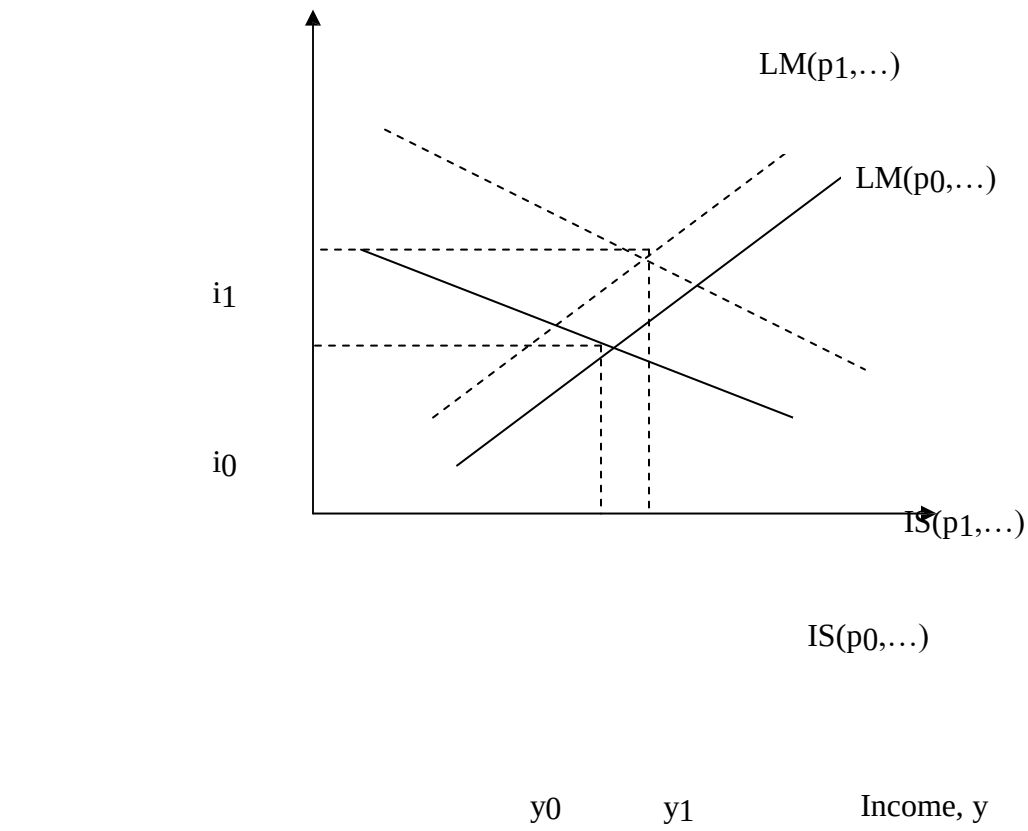


Figure 3. The effect of a higher price level ($p_0 < p_1$) in the ISLM model when the Fisher debt effect dominates the Pigou and Keynes effects.

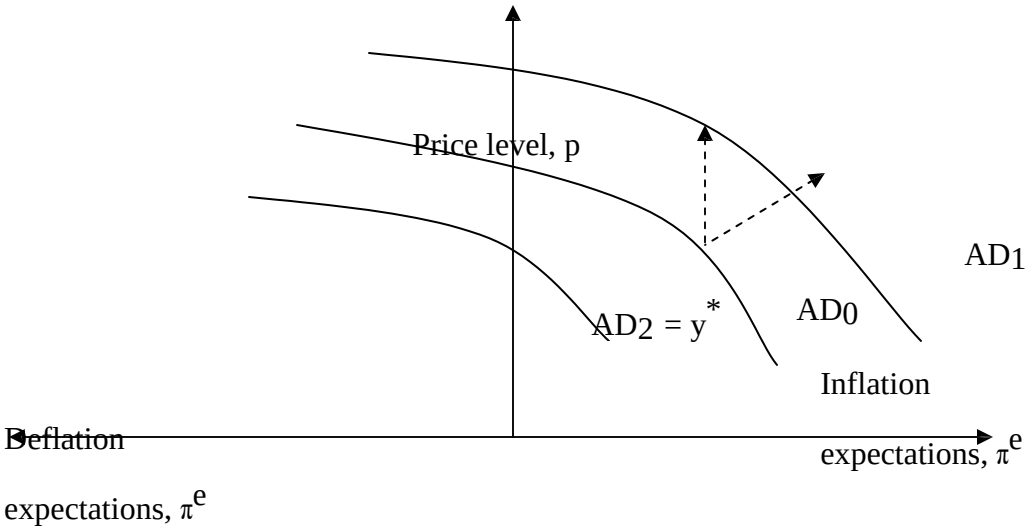

Price level, p
AD1
AD0
AD2 = y*
Inflation
Deflation
expectations, πe
expectations, πe

Figure 4. Iso-AD contour map when the Fisher debt effect dominates the Pigou and Keynes effects. $AD_2 < AD_0 < AD_1$.

Lesson-13

Insurance Corporations and Housing Finance Money Markets

Structure

13.1 Introduction

Objectives

After reading this lesson you have understand about various important investment institutions particularly, it describe the Unit Trust of India, life Insurance Corporation of India, and General Insurance Corporation of India. It also describe about the role and important functions, objectives, advantages and disadvantages of these Investment Institutions.

13.2 Investment Institutions

The important investment institutions are:

1. Unit Trust of India (UTI)
2. Life Insurance Corporation of India (LIC)
3. General Insurance Corporation of India (GIC)

13.3 Life Insurance Corporation of India (LIC)

The Life Insurance Corporation of India was set up under the LIC Act, 1956 under which the life insurance was nationalised. As a result, business of 243 insurance companies was taken over by LIC on 1-9-1956. It is basically an investment institution, in as much as the funds of policy holders are invested and dispersed over different classes of securities,

industries and regions, to safeguard their maximum interest on long term basis. Life Insurance Corporation of India is required to invest not less than 75% of its funds in Central and State Government securities, the government guaranteed marketable securities and in the socially-oriented sectors. At present, it is the largest institutional investor. It provides long term finance to industries. Besides, it extends resource support to other term lending institutions by way of subscription to their shares and bonds and also by way of term loans. Life Insurance Corporation of India which has entered into its 57th year has emerged as the world's largest insurance co. in terms of number of policies covered. The Life Insurance Corporation of India's total coverage of policies including individual, group and social schemes has crossed the 11 crore.

Objectives of Life Insurance Corporation of India

The Life Insurance Corporation of India was established with the following objectives:

1. Spread life insurance widely and in particular to the rural areas, to the socially and economically backward claries with a view to reaching all insurable persons in the country and providing them adequate financial cover against death at a reasonable cost

2. Maximisation of mobilisation of people's savings for nation building activities. 3. Provide complete security and promote efficient service to the policy-holders at economic premium rates.

4. Conduct business with utmost economy and with the full realisation that the money belong to the policy holders.

5. Act as trustees of the insured public in their individual and collective capacities.

6. Meet the various life insurance needs of the community that would arise in the changing social and economic environment

7. Involve all people working in the corporation to the best of their capability in furthering the interest of the insured public by providing efficient service with courtesy.

13.4 Role and Functions of Life Insurance Corporation of India

The role and functions of Life Insurance Corporation of India may be summarised as below:

1. It collects the savings of the people through life policies and invests the fund in a variety of investments.

2. It invests the funds in profitable investments so as to get good return. Hence the policy holders get benefits in the form of lower rates of premium and increased bonus. In short, Life Insurance Corporation of India is answerable tothe policy holders.

3. It subscribes to the shares of companies and corporations. It is a major shareholder in a large number of blue chip companies.

4. It provides direct loans to industries at a lower rate of interest. It is giving loans to industrial enterprises to the extent of 12% of its total commitment.

5. It provides refinancing activities through SFCs in different states and other industrial loan-giving institutions.

6. It has provided indirect support to industry through subscriptions to shares and bonds of financial institutions such as IDBI, IFCI, ICICI, SFCs etc. at the time when they required initial capital. It also directly subscribed to the shares of Agricultural Refinance Corporation and SBI.

7. It gives loans to those projects which are important for national economic welfare. The socially oriented projects such as electrification, sewage and water channelising are given priority by the Life Insurance Corporation of India.

8. It nominates directors on the boards of companies in which it makes its investments. 9. It gives housing loans at reasonable rates of interest.

10. It acts as a link between the saving and the investing process. It generates the savings of the small savers, middle income group and the rich through several schemes.

11. Formerly LIC has played a major role in the Indian capital market. To stabilise the capital market it has underwritten capital issues. But recently it has moved to other avenues of financing. Now it has become very selective in its underwriting pattern.

13.5. General Insurance Corporation of India (GIC)

General insurance industry in India was nationalised and a government company known as General Insurance Corporation of India was formed by the central government in November, 1972. General insurance companies have willingly catered to these increasing demands and have offered a plethora of insurance covers that almost cover anything under the sun. Any insurance other than 'Life Insurance' falls under the classification of General Insurance. It comprises of:-

a. Insurance of property against fire, theft, burglary, terrorism, natural disasters etc

b. Personal insurance such as Accident Policy, Health Insurance and liability insurance which cover legal liabilities.

c. Errors and Omissions Insurance for professionals, credit insurance etc.

d. Policy covers such as coverage of machinery against breakdown or loss or damage during the transit.

e. Policies that provide marine insurance covering goods in transit by sea, air, railways, waterways and road and cover the hull of ships.

f. Insurance of motor vehicles against damages or accidents and theft

All these above mentioned form a major chunk of non-life insurance business.

General insurance products and services are being offered as package policies offering a combination of the covers mentioned above in various permutations and combinations. There are package policies specially designed for householders, shopkeepers, industrialists, agriculturists, entrepreneurs, employees and for professionals such as doctors, engineers, chartered accountants etc. Apart from standard covers, General insurance companies also offer customized or tailor-made policies based on the personal requirements of the customer.

13.6 Classification of Indian General Insurance Industry

General Insurance is also known as Non-Life Insurance in India. There are totally 16 General Insurance (Non-Life) Companies in India. These 16 General Insurance companies have been classified into two broad categories namely:

a) PSUs (Public Sector Undertakings)

b) Private Insurance Companies

a) PSUs (Public Sector Undertakings):-These insurance companies are wholly owned by the Government of India.

There are totally 4 PSUs in India namely:-• National Insurance Company Ltd

• Oriental Insurance Company Ltd

• The New India Assurance Company Ltd

• United India Insurance Company Ltd

b) Private Insurance Companies:-There are totally 12 private General Insurance companies in India namely:-• Apollo DKV Health Insurance Ltd

• Bajaj Allianz General Insurance Co. Ltd

• Cholamandalam MS General Insurance Co. Ltd

• Future General Insurance Company Ltd

• HDFC Ergo General Insurance Co Ltd

• ICICI Lombard General Insurance Ltd

• Iffco Tokio General Insurance Pvt Ltd

• Reliance General Insurance Ltd

• Royal Sundaram General Insurance Co Ltd

• Star Health and Allied Insurance

• Tata AIG General Insurance Co Ltd

• Universal Sompo General Insurance Pvt Ltd

13.7 Unit Trust of India (UTI)

The Unit Trust of India was set up in February 1964 under the Unit Trust of India Act of 1963, in the public sector. It plays an important role in mobilizing savings of investors through sale of units and channelizing them into corporate investments. Over the years, it has introduced a variety of growth schemes to meet needs of diverse section of investors. After an amendment to its Act in April 1986, Unit Trust of India has started extending assistance to corporate sector by way of term loans, bills rediscounting, equipment leasing and hire purchase facilities. The management of the trust is entrusted to the Board of Trustees. The chairman of the Board and 4 other trustees are appointed by the RBI. One trustee each is nominated by the LIC and the SBI, and 2 other trustees are elected by other subscribers to the capital of the trust.

Unit Trust of India has recently set up an Asset Management Company to bring some of its mutual fund schemes under its purview. It also engaged in investment banking business, stock broking, consultancy etc. Sanctions up to March, 1993, amounted to Rs. 7520.6 crores. One of the striking features of purpose-wise UTI sanctions reveals that working capital requirements of industrial concerns have received the maximum attention (over 50-55%). Similarly private sector accounts for the highest share in Unit Trust of India sanctions (about 67%) followed by public sector (32%). Unit Trust of India is the first unit trust in the public sector in the world.

13.8 Objectives of Unit Trust of India

The basic objective of the establishment of Unit Trust of India was to encourage investment and participation in the income, profits and gains accruing to the corporation from the acquisition, holding, management and dispersal of securities. The other objectives are as follows :

1. To stimulate and pool the savings of the middle and low income groups.

2. To enable unit holders to share the benefits and prosperity of the rapidly growing industrialisation in the country.

3. To sell units among as many investors as possible.

4. To invest the money raised from the sale of units and its own capital in corporate and industrial securities

5. To pay dividend to the unit holders.

13.9 Advantages of Units of Unit Trust of India

1. Investment in units is safe.

2. Units are highly liquid.

3. Unit holders get a steady and decent income in the form of dividend.

4. Dividend on unit is exempt from income tax upto a certain amount.

5. Wealth tax payers get a benefit.

13.10. Disadvantages of Units of Unit Trust of India

1. Unit holders have no right to attend the annual general meeting of the Unit Trust of India.

2. Unit holders are not entitled to certain concessions which are offered to shareholders by certain companies

3. Only 90% of the income of the trust can be distributed among the unit holders.

13.11 Summary

In this lesson you have learnt that important investment institutions such as the Unit Trust of India, life Insurance Corporation of India, and General Insurance Corporation of India. It also discussed in detail about the role and important functions, objectives, advantages and disadvantages of these Investment Institutions and it also discussed how helpful to the society as well as nations.

13.12 In text Questions

1. Explain the role, functions and important objectives of Unit Trust of India (UTI)

2. How Life Insurance Corporation of India (LIC) helpful to the society as well- Explain

3. Give the role and importance of General Insurance Corporation of India (GIC)

Lesson-14

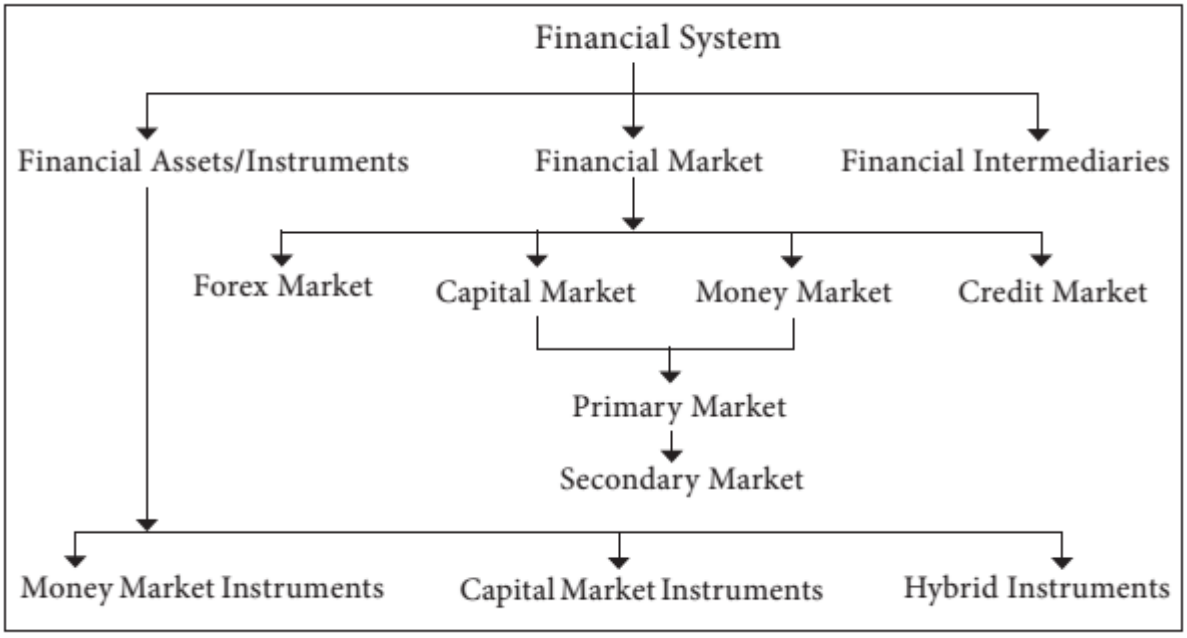
Structure of Financial Institutions and Financial Markets

14.1 FINANCIAL INSTITUTIONS

Indian Financial System

India's financial system is a very strong and efficient one which is evidenced by India's flourishing stock markets, fast-growing mutual funds, and capable banking sector.

Indian financial system consists of financial market, financial instruments and financial intermediation (See the figure below)



Shortcomings of Indian Financial System

The Indian financial system's shortcomings fall largely into three areas.

➢ First, formal financial institutions attract only half of India's household savings

➢ Second, these financial institutions allocate more than half of the capital to the economy's least productive areas: state-owned enterprises (SOEs), agriculture, and the unorganized sector (made up mostly of tiny businesses).

➢ Third, since the financial system is inefficient in both of its main task mobilizing savings and allocating capital, Indian borrowers pay more for capital and depositors receive less than they do in comparable economies.

Meaning of Financial Institutions

Financial institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet. They mobilize saving of the

surplus units and allocate them in productive activities promising a better rate of return. Financial institutions also provide services to entities (individual, business, government) seeking advice on various issues ranging from restructing to diversification plans. They provide whole range of services to the entities who want to raise funds from the markets or elsewhere. Financial Institutions are also termed as financial intermediaries because they act as middlemen between the savers (by accumulating funds from them) and borrowers (by lending these funds). Banks also act as intermediaries because they accept deposits from a set of customers (savers) and lend these funds to another set of customers (borrowers).

Like-wise investing institutions such as GIC, LIC, mutual funds etc. also accumulate savings and lend these to borrowers, thus performing the role of financial intermediaries. Financial institution's role as intermediary differs from that of a broker who acts as an agent between buyer and seller of a financial instrument (equity shares, preference, debt); thus facilitating the transaction but does not personally issue a financial instrument. Whereas, financial intermediaries are mobilize savings of the surplus units and lend them to the borrowers in the form of loans and advances (i.e. by creating a financial asset). They earn profit from the difference between rate of interest charged on loans and rate of interest paid on deposits (savings). In short, they repackage the depositor's savings into loans to the borrowers. As financial intermediaries, they meet the short-term as well as long-term needs of the borrowers and provide liquidity to the savers. Deposits are payable on demand by the customers. Banks are in a position to avoid the situation of ill liquidity while borrowing for short period sand lending for long term by mobilizing savings from diversified set of depositors. RBI also has made it mandatory for the banks to keep a certain percentage of deposits as cash reserves with itself to avoid the situation of ill-liquidity.

Types of Financial Institutions

Financial institutions can be classified into two categories:

I. Banking Institutions

II. Non-Banking Financial Institutions

I. Banking Institutions

Indian banking industry is subject to the control of the Central Bank (i.e. Reserve Bank of India). The RBI as the apex institution organizes, runs, supervises, regulates and

develops the monetary system and the financial system of the country. The main legislation governing commercial banks in India is the Banking Regulation Act, 1949.

The Indian banking institutions can be broadly classified into two categories:

1. Organized Sector

2. Unorganized Sector

1. Organized Sector: The organized banking sector consists of commercial banks, cooperative banks and the regional rural banks.

(a) Commercial Banks: The commercial banks may be scheduled banks or non-scheduled banks. At present only one bank is a non-scheduled bank. All other banks are scheduled banks. The commercial banks consist of 27 public sector banks, private sector banks and foreign banks. Traditionally, commercial banks accepted deposits and met the short and medium term funding needs of the industry. But now, since 1990's, banks are also funding the long terms needs of the industry particularly the infrastructure sector. The liberalization measures initiated in the Indian economy, led to the entry of large private sector banks in 1993. This has increased competition among public sector banks and quality of services has improved. A major development in the Indian banking industry was the entry of major banks in merchant banking. The merchant bankers are financial intermediaries providing a range of financial services to the corporate and investors. Some of the merchant banker's activities include issue management and underwriting, project counselling and finance, mergers and acquisition advice, portfolio management service etc.

(b) Co-operative Banks: An important segment of the organized sector of Indian banking is the co-operative banking. The segment is represented by a group of societies registered under the Acts of the States relating to co-operative societies. In fact, cooperative societies may be credit societies or non-credit societies. Different types of co-operative credit societies are operating in the Indian economy. These institutions can be classified into two broad categories : (a) Rural credit societies which are primarily non-agricultural. For the purpose of agricultural credit there are different co-operative credit institutions to meet different kinds of needs. For example, short and medium term credit is provided through three tier federal structure. At top is the apex body i.e., state co-operative bank ; in the middle there are district cooperative banks or central co-operative banks, at the grass root level i.e., village level there are primary agricultural credit societies. For medium to long terms loans to agriculture, specialized co-operative

societies have been formed. These are called 'Land Development Banks'. The Land Development Banks movement started in 1929. In the beginning they were named "Central Land Mortgage Banks". Land development banking is a two tier structure. At the state level there are state or central land development banks. At local level there are branches of these banks and primary land development banks. At the national level they have formed All-India Land Development Bank's Union. (c) Regional Rural Banks (RRBs) : Regional Rural Banks were set by the state government and the sponsoring commercial banks with the objective of developing the rural economy. Regional rural banks provide banking services and credit to small farmers, small entrepreneurs in the rural areas. The regional rural banks were set up with a view to provide credit facilities to weaker sections. They constitute an important part of the rural financial architecture in India. There were 196 RRBs at the end of June 2002, as compared to 107 in 1981 and 6 in 1975. RBI extends refinance assistance at a concessional rate of 3 per cent below the bank rate to RRBs. IDBI, NABARD and SIDBI are also required to provide managerial and financial assistance to RRBs under the Regional Rural Bank Act.

Government decided to restructure the RRB's on the recommendation of Bhandari Committee in 1994-95. As a result, an amount of Rs.360 crores was allocated towards the restructuring programme. The State Bank of India took several measures of managerial and financial restructuring including enhancement of issued capital and placement of officers of proven ability to head the RRBs. NABARD took several policy measures such as quarterly / half yearly review of RRBs by the sponsor banks, framing of Appointment and Promotion Rules (1998) for the staff ofRRBs, introduction of Kissan Credit Cards, introduction of self- help groups etc., for improving the overall performance of RRBs. (d) Foreign Banks : Foreign Banks have been in India from British days. ANZ Grindlays Bank has its presence in number of places with 56branches. The Standard and Chartered Bank has 24 branches and Hongkong Bank has 21 branches. All other foreign banks have branches less than 10. Obviously, these banks have concentrated on corporate clients and have been specializing in area relating to international banking. With the deregulation of banking in 1993, a number of foreign banks are entering India or have got the licenses. Such new foreign banks are: Barclays Bank, Bank of Ceylon, Bank Indonesia International, State Commercial Bank of Mauritius, Development Bank of Singapore, Chase Manhattan Bank, Dresdner Bank, Overseas Chinese Bank Corporation, Chinatrust Commercial Bank, Krug Thai Banking Public Company Ltd., Cho Hung Bank, Commerz

Bank, Fuji Bank and Toronto Dominion Bank. The list is indicative of the fact that India is going to have greater presence of foreign banks in future. However, despite low deposits these foreign banks reflect greater degree of efficiency and productivity.

2. Unorganized Sector: In the unorganized banking sector are the indigenous bankers, money lenders, seths, sahukarscarrying out the function of banking.

(a) Indigenous Bankers : Indigenous bankers are the fore gathers of modern commercial banks. These are the individuals or partnership firms performing the banking functions. They also act as financial intermediaries. As the term indigenous indicates, they are the local bankers. The geographical area covered by the indigenous bankers is much larger than the area covered by commercial banks. They can be found in all parts of the country although their names, styles of functioning and the functions performed by the them may differ. In west India they may be known as Gujarati shroffs or Marwar, in South India they may be called Chettiars, in North India they may be called sahukars, etc. Indigenous bankers provide finance for productive purpose directly to trade and industries, and indirectly, through money lenders and traders to agriculturists with whom they find it difficult to establish direct relations. They keep in touch with traders and small industrialists and finance marketing on a sizeable scale. Lending is conducted on the basis of promissory notes, or receipts signed by borrowers acknowledging loans, and stating the agreed rate of interest, or bonds written out on stamped legal forms, or through signing of bankers books by borrowers. For large land, houses or other property are held as mortgage.

(b) Money Lenders : Money lenders depends entirely on their own funds for the working capital. Money lenders may be rural or urban, professional or non-professional. They include large farmers merchants, traders, arhatias, goldsmiths, village shopkeepers, sardars of labourers, etc. The methods and areas of operation differ from money lender to money lender.

14.2 NON-BANKING INSTITUTIONS

The non-banking institutions may be categorized broadly into two groups :

(a) Organized Financial Institutions.

(b) Unorganized Financial Institutions.

(a) Organized Financial Institutions: The organized non-banking financial institutions include :

1. Development Finance Institutions : These include :

(a) The institutions like IDBI, ICICI, IFCI, IIBI, IRDC, at all India level.

(b) State Finance Corporation (SFCs), State Industrial Development Corporation (SIDCs) at the state level.

(c) Agriculture Development Finance Institutions as NABARD, Land Development Banks etc.

Development banks provide medium and long term finance to the corporate and industrial sector and also take up promotional activities for economic development of the country.

2. Investment Institutions: It includes those financial institutions which mobilize savings of the public at large through various schemes and invest these funds in corporate and government securities. These include LIC, GIC,UTI, and mutual funds.

(b) Unorganized Financial Institutions: The unorganized non-banking financial institutions include number of non-banking financial companies (NBFCs) providing whole range of financial service. These include hire-purchase and consumer finance companies, leasing companies, housing finance companies, factoring companies, credit rating agencies, merchant banking companies etc. NBFCs mobilize public funds and provide loan able funds. There has been remarkable increase in the number of such companies since 1990's.

14.3 SETTING UP OF FINANCIAL INSTITUTIONS

Government control over the sources of credit and finance led to the establishment of many financial institutions in the public sector. The main objective was to provide medium and long-term industrial finance to the corporate sector. These financial institutions included: Development Finance Institutions Development banks are the institutions engaged in the promotion and development of industry, agriculture and other key sector. A number of development finance institutions at National/All India Level as well as Regional/State Level were set up.

The foreign rulers in India did not take much interest in the industrial development of the country. They were interested to take raw materials to England and bring back finished goods to India. The Government did not show any interest for setting up institutions needed for industrial financing. The recommendation for setting up industrial financing institutions was made in 1931 by Central Banking Enquiry Committee but no concrete steps were taken. In 1948, Reserve Bank had undertaken a detailed study to find out the need for specialized institutions. It was in 1948that the first development bank i.e. industrial Finance Corporation of India (IFCI) was established. IFCI was assigned the

role of a gap- filler which implied that it was not expected to compete with the existing channels of industrial finance. It was expected to provide medium and long term credit in industrial concerns only when they could not raise sufficient finances by raising capital or normal banking accommodation.

In view of the vast size of the country and needs of the economy it was decided to set up regional development banks to cater to the needs of the small and medium enterprises. In 1951, Parliament passed State Financial Corporation Act. Under this Act state governments could establish financial corporation for their respective regions. At present there are 18 State Financial Corporation's (SFC's) in India.

The IFCI and State Financial Corporation served only a limited purpose. There was a need for dynamic institution which could operate as true development agencies. National Industrial Development Corporation (NIDC) was established in 1954 with the objective of promoting industries which could not serve the ambitious role assigned to it and soon turned to be a financing agency restricting itself to modernization and rehabilitation of cotton and jute textile industries.

The Industrial Credit and Investment Corporation India Ltd. (ICICI) were established in 1955 as a joint stock company. ICICI was supported by Government of India, World Bank, Common Wealth Development Finance Corporation and other foreign institutions. It provides term loans and takes an active part in the underwriting of and direct investment in the shares of industrial units. Though ICICI was established in private sector but its pattern of shareholding and methods of raising funds gives it the characteristic of a public sector financial institution. ICICI Ltd. has now merged into ICICI Bank. Another institution, Refinance Corporation for Industry Ltd. (RCI) was set up in 1958 by Reserve Bank of India, LIC and Commercial Banks. The purpose of RCI was to provide refinance to commercial banks and SFC's against term loans granted by them to industrial concerns in private sector. In 1964, Industrial Development Bank of India (IDBI) was set up as an apex institution in the area of industrial finance. RCI was merged with IDBI, IDBI was a wholly owned subsidiary of RBI and was expected to co-ordinate the activities of the institutions engaged in financing, promoting to developing industry.

However, it is no longer a wholly owned subsidiary of the Reserve Bank of India. Recently it made a public issue of shares to increase its capital. In order to promote industries in the state another type of institutions, namely, the State Industrial

Development Corporations (SIDC's) were established in the sixties to promote medium scale industrial units. The state owned corporation have promoted a number of projects in the joint sector and assisted sector. At present there are 28 SIDC's in the country. The State Small Industries Development Corporations (SSIDC's) were also set up to cater to the needs of industry at state level. These corporations manage industrial estates, supply raw materials, run common service facilities and supply machinery on hire-purchase basis. Some states have established specialized corporations for the development of infrastructure, agro–industries, etc.

Investing Institutions

A number of other institutions also participated in industrial financing by mobilizing public savings through introduction of insurance schemes, mutual funds, units etc. These institutions also called investing included Unit Trust of India (UTI) established in 1964, Life Insurance Corporation of India in 1956 and General Insurance Corporation in 1973.

Other Institutions

Some more units were set up to provide help in specific areas such as rehabilitation of sick units, export finance, agriculture and rural development. Industrial Reconstruction Corporation of India Ltd. (RCI) was set up in 1971 for the rehabilitation of sick units. In 1982 the Export – Import Bank of India (Exim Bank) was established to provide financial assistance to exporters and importers. In order to meet credit needs of agriculture and rural sector, National Bank for Agriculture and Rural Development (NABARD) was set up in 1982. It is responsible for short term, medium – term and long term financing of agriculture and allied activities. The institutions such as Film Finance Corporation, Tea Plantation Finance Scheme, Shipping Development Fund, Newspaper Finance Corporation, Handloom Finance Corporation, and Housing Development Finance Corporation also provide financial and other facilities in various areas. Indian financial system has undergone massive changes since the announcement of new economic policy in 1991. Liberalization/globalization/deregulation has transformed Indian economy from closed to open economy. The corporate industrial sector structure has also undergone changes due to deli censing of industries, financial sector reforms or reforms in banking/capital market, disinvestments in public sector undertakings (PSUs), reforms in taxation and company law etc. Government role in the distribution of finance and credit has declined over the years. Financial system is focusing more attention towards the development of capital market which is emerging as the main agency for the allocation of

resources among the public, private sector and state government. Major development that have taken place in the Indian financial system are briefly discussed below:

1. Entry of Private Sector: Since 90's, Government control over financial institutions has diluted in a phased manner. Public/Development Financial Institutions have been converted into companies, allowing them to issue equity/bonds to the public. Government has allowed private sector to enter into banking and insurance sector. IFCI has been converted into a public company.

2. Changing Role of Development Finance Institutions (DFIs): DFIs performed the role of term-lending institutions extending loans for project finance, underwriting, direct subscription, lease financing etc. They received funds from the Government and the RBI. But now, there is remarkable shift in the activities of DFIs : (a) DFIs are engaged in non-fund based financial activities such as merchant banking, project counseling, portfolio management services, mergers and acquisitions, new issue management etc.

(b) DFIs raise funds through issue of bonds carrying floating rate of interest or bonds without government guarantee.

(c) Earlier, DFIs sponsored infrastructural institutions such as Technical Consultancy Organisation (TCOs), Management Development Institution (MDI) and The Institute for Financial Management and Research (IFMR). Then, focus shifted to development of capital market. As a result, following institutions were promoted by the DFIs.

(i) Credit Rating Information Services of India Ltd. (CRISIL).

(ii) Investment Information and Credit Rating Agency Ltd. (ICRA)

(iii) Credit Analysis and Research Ltd. (CARE)

(iv) Over the Counter Stock Exchange of India. (OTCEI) Ltd.

(v) National Stock Exchange (NSE) Ltd.

(vi) Stock Holding Corporation of India (SHCI) Ltd.

(vii) IFCI Financial Services Ltd.

(viii) IFCI Investors Services Ltd.

(ix) IFCI Custodial Services Ltd.

(x) ICICI- Securities and Finance Ltd.

3. Emergence of Non- Banking Financial Companies (NBFCs) : In the unorganized non-banking sector, number of Non-banking financial companies have emerged providing financial services partly fee-based and partly asset/fund based. Their activities include equipment leasing, hire-purchase finance, bills discounting, loans/investments, venture

capital, housing finance etc. Fee based services include portfolio management, issue management, loan syndication, merger and acquisition etc.

4. Growth of Mutual Funds Industry: Initially, UTI was the single organisation issuing the mutual funds units. But presently, the mutual funds are sponsored not only by UTI but also by banks, insurance organization, FIIs, private sector. There are offshare/country funds being sponsored by FIIs and Indian FIs. Mutual funds are gaining popularity among the small investors due to (i) tax exemption on income from mutual funds and (ii) units of mutual funds if held for 12 months are to be treated as long-term asset, for the purpose of capital gains tax.

5. Securities and Exchange Board of India (SEBI) : The Securities and Exchange Board of India was established under the SEBI Act, 1992 with the following purposes : -

(i) To protect the interest of investors in securities;

(ii) To promote the development of the securities market;

(iii) To regulate the securities market; and

(iv) For matters connected therewith or incidental thereto.

Significant Changes in Financial System

Some of the significant changes that have taken place over the last few years and that may have implications on the Indian financial system are listed below.

1. The Unit Trust of India, the leading mutual fund organisation has been split into two parts as a consequence of the repeal of the UTI Act.

2. Private sector has been allowed in the insurance sector thus breaking the monopoly of LIC and GIC. GIC has been delinked from its four subsidiaries.

3. The introduction of derivative trading including index/stock/interest futures and options has also been one of the significant development having implications on the financial system.

4. The merger of the ICICI Ltd. and IDBI into ICICI Bank and IDBI and respectively and the proposed merger of IFCI into Punjab National Bank.

14.4 ROLE AND IMPORTANCE OF FINANCIAL INSTITUTIONS

Financial institutions (intermediaries) are business organisations serving as a link between savers and investors and so help in the credit–allocation process. Good financial institutions are vital to the functioning of an economy. If finance were to be described as the circulatory system of the economy, financial institutions are its brain. They make decisions that tell scarce capital where to g o and ensure that it is used most efficiently. It

has been confirmed by research that countries with developed financial institutions grow faster and countries with week ones are more likely to undergo financial crises.

Lenders and borrowers differ in regard to terms of risk, return and term of maturity. Financial institutions assist in resolving this conflict between lenders and borrowers by offering claims against themselves and, in turn, acquiring claims on the borrowers. The former claims are referred to as indirect (secondary) securities and the latter as direct (primary) securities.

Financial institutions provide three transformation services:

(i) Liability, asset and size transformation consisting of mobilization of funds, and their allocation by providing large loans on the basis of numerous small deposits.

(ii) Maturity transformation by offering the savers tailor-made short–term claims or liquid deposits and so offering borrowers long-term loans matching the cash flows generated by their investment.

(iii) Risk transformation by transforming and reducing the risk involved in direct lending by acquiring diversified portfolios. Through these services, financial institutions are able to tap savings that are unlikely to be acceptable otherwise. Moreover, by facilitating the availability of finance, financial institutions enable the consumer to spend in anticipation of income and the entrepreneur to acquire physical capital. Financial institutions provide means and mechanism of transferring resources from those who have an excess of income over expenditure to those who can make productive use of the same. The commercial banks and investment institutions mobilize savings of people and channelize them into productive uses. Economic development of a country needs sufficient financial resources, adequate infrastructural faculties and persons who can take the initiative of setting up units for providing goods and services. Financial institutions provide all types of assistance required for development. These institutions help economic development in the following ways : 1. Providing Funds. The underdeveloped countries have low levels of capital formation. Due to low incomes, people are not able to save sufficient funds which are needed for setting up new units and also for expansion, diversification and modernization of existing units. These persons who have the capability of starting a business but does not have requisite help approach financial institutions for help. These institutions help large number of persons for taking up some industrial activity. The addition of new industrial units and increasing the activities of existing units will

certainly help in accelerating the pace of economic development. Financial institutions have large investible funds which are used for productive purpose.

2. Infrastructural Facilities. Economic development of a country is linked to the availability of infrastructural facilities. There is a need for roads, water, sewerage, communication facilities, electricity etc. Financial institutions prepare their investment policies by keeping national priorities in mind. The institutions invest in those areas which can help in increasing the development of the country. Indian industry and agriculture is facing acute shortage of electricity. All Indian institutions are giving priority to invest funds in projects generating electricity. These investments will certainly increase the availability of electricity. Small entrepreneurs cannot spare funds for creating infrastructural facilities. To overcome this problem institutions at state level are developing industrial estates and provide sheds, having all facilities, at easy installments. So financial institutions are helping in the creation of all those facilities which are essential for the development of a country.

3. Promotional Activities. An entrepreneur faces many problems while setting up a new unit. One has to undertake a feasibility report, prepare project report, complete registration formalities, seek approval from various agencies etc. All these things require time, money and energy. Some people are not able to undertake this exercise or some do not even take initiative. Financial institutions have the expertise and manpower resources for undertaking the exercise of starting a new unit. So these institutions take up this work on behalf of entrepreneurs. Some units may be set up jointly with some financial institutions and in that case the formalities are completed collectively. Some units may not have come up had they not received promotional help from financial institutions. The promotional role of financial institutions is helpful in increasing the development of a country.

4. Development of Backward Areas. Some areas remain neglected because facilities needed for setting up new units are not available there. The entrepreneurs set up new units at those places which are already developed. It causes imbalance in economic development of some areas. In order to help the development of backward areas, financial institutions provide special assistance to entrepreneurs for setting up new units in these areas. IDBI, IFCI, ICICI give priority in giving assistance to units set up in backward areas and even charge lower interest rates on lending. Such efforts certainly encourage entrepreneurs to set up new units in backward areas. The industrial units in the these areas

improve basic amenities and create employment opportunities. These measures will certainly help in increasing the economic development of backward areas.

5. Planned Development. Financial institutions help in planned development of the economy. Different institutions earmark their spheres of activities so that every business activity is helped. Some institutions like SIDBI, SFC's especially help small scale sector while IFCI and SIDC's finance large scale sector or extend loans above a certain limit. Some institutions help different segments like foreign trade, tourism etc. In this way financial institutions devise their roles and help the development in their own way. Financial institutions also follow the development priorities set by central and state Governments. They give preference to those industrial activities which have been specified in industrial policy statements and in five year plans. Financial institutions help in the overall development of the country.

6. Accelerating Industrialization. Economic development of a country is linked to the level of industrialization there. The setting up of more industrial units will generate direct and indirect employment, make available goods and services in the country and help in increasing the standard of living. Financial institutions provide requisite financial, managerial, technical help for setting up new units. In some areas private entrepreneurs do not want to risk their funds or gestation period is long but the industries are needed for the development of the area, financial institutions provide sufficient funds for their development. Since 1947, financial institutions have played a key role in accelerating the pace of industrialization. The country has progressed in almost all areas of economic development.

7. Employment Generation. Financial institutions have helped both direct and indirect employment generation. They have employed many persons to man their offices. Besides office staff, institutions need the services of experts which help them in finalizing lending proposals. These institutions help in creating employment by financing new and existing industrial units. They also help in creating employment opportunities in backward areas by encouraging the setting up of units in those areas. Thus financial institutions have helped in creating new and better job opportunities.

14.5 FINANCIAL INSTITUTIONS

Financial Institutions are an important component of financial system. Financial institutions are also known as financial intermediaries. This is because they collect the savings from the savers and pass on the same to desired channels. They provide

finance for the development of various sectors of the economy such as industry, agriculture, service etc. Thus financial institutions play an important role in the financial system or economy.

Role of Financial Institution in the Financial System

- Financial institutions are financial intermediaries.
- They provide the means and mechanism of transferring the resources from those whose income is more than expenditure to those who need these resources for productive purposes.
- The savings of the savers will reach the borrowers through the financial intermediaries in the form of financial instruments such as shares, stocks, debentures, deposits, loans etc. Thus, they play the role of intermediate between the savings and investments.
- They provide safety, liquidity and ensure return for savings.
- Financial institutions develop the saving habit among the people.
- They mobilise huge amount of savings for the industrial development as a productive capital. The financial institutions supply capital to the small, medium and large scale industries in India in the form of capital, venture capital, and services to promote the industrial growth in India.
- These contribute for the growth and development of industries, agriculture etc.

Classification of Financial Institutions

All financial institutions in India may be broadly clarified into two-banking financial institutions and non-banking financial institutions.

I. Banking Financial Institutions

Banking financial institutions are those financial institutions which carry on banking activities. Banking business is carried on by these institutions after obtaining an approval under Banking Regulation Act, 1949 and RBI. It accepts deposits from the public. It lends money to people engaged in commerce, industry and agriculture. It finances foreign trade and deals in foreign exchange. It provides short, medium and long term credit. It acts as an agent of RBI. It deals in stocks and shares, trusteeship, executorships etc. In short, the bank can be aptly described, as 'department store of finance' because it engages itself in every form of banking business. Banking financial institutions mainly comprise of commercial banks.

A. Commercial banks

A Bank is a financial Institution whose main business is accepting deposits and lending loans. A Banker is a dealer of money and credit. Banking is an evolutionary concept i.e. expanding its network of operations. According to Banking revolutions Act 1949, the word BANKING has been defined as "Accepting for the purpose of lending and investment of deposits of money from the public repayable on demand or otherwise".

Functions of Commercial Banks

Globalisation transformed commercial banks into super markets of financial services. The important functions of commercial banks are explained below:

I. Primary Functions

These are further classified into 2 categories

i) Accepting Deposits: -Deposits are the capital of banker. Therefore, it is first Primary function of the banker. He accepts deposits from those who can save and lend it to the needy borrowers. The size of operation of every bank is determined by size and nature of Deposits. To attract the saving from all sort (categories) of individuals, Commercial banks accepts various types of deposits account they are:

a) Fixed Deposits

b) Current Deposits

c) Saving Bank account

d) Recurring Deposits

ii) Lending Loans: -The 2 nd important function of the commercial bank is advancing loans.Bank accepts deposits to lend it at higher rate of interest. Every Commercial Bank keep the rate of interest on its deposit at lower level or less that what he charges on its loans which is as NIM (Net Interest Margin). The banker advances different types of loans to the individual and firms. They are: -

a) Overdraft

b) Cash Credit

c) Term Loan

d) Discounting Bill

II) Secondary Functions

i) Agency functions:

Bankers act as an agent to the customers it means he performs certain functions on behalf of the customers such services are called Agency Services. Example:

a) Bank pay electricity bill, water bill, Insurance Premium etc.

b) They guide the customer in Task Planning.

c) Bank provides safety locker facility.

d) Pay salaries of customer's employees.

ii) General Utility Services: -Bankers are the past of society. They offer: several services to general public they are:-

a) It provides cheap remittance (transfer) facilities.

b) The banks issue traveller cheque for safe travelling to its customers.

c) Banks accepts and collects foreign Bills of Exchanges.

d)Other than these services the bankers also provide ATM services, Internet Banking, Electronic fund transfer (EFT), E-Banking to provide quick and proper services to its customers.

iii) Credit Creation: -It is a unique function of Commercial Banks. When a bank advances loan to its customer if doesn't lend cash but opens an account in the borrowers name and credits the amount of loan to that account. Thus, whenever a bank grants loan, it creates an equal amount of bank deposits. Creation of deposits is called Credit Creation. In simple words we can define Credit creation as multiple expansions of deposits. Creation of such deposits will results an increase in the stock deposits. Creation of such deposits will results an increase in the stock of money in an economy.

II. Non-Banking Financial Institutions

These are the financial institutions which are not permitted to carry on the banking activities as per Banking Regulation Act, 1949 and RBI regulations. These institutions have been established by special legislations to provide finance to specified categories of industries or persons.

Classification of Non-Banking Financial Institutions

Non-banking financial institutions can be classified to three. They are :

1. All-India Financial Institutions or All-India Development Banks or Specialised Financial Institutions

2. State Level Financial Institutions

3. Investment Institutions

These may be described in the following pages:

A. All-India Financial Institutions

Government of India has nationalised 20 commercial banks (excluding subsidiaries of SBI) so far. A number of financial institutions have also been set up to supply finance to industry and agriculture. Unfortunately, these commercial banks and financial institutions fail to provide long term finance to industries. With the objective of giving term loans, Govt. has set up some specialised financial institutions. These specialised financial institutions are called development banks. The development banks have to sacrifice business principles of conventional financial institutions and pay due regard to public interest so as to act as an instrument of economic development in conformity with national objectives, plans and priorities. Development banks are expected to act as catalysts in performing developmental and promotional functions. As regards banking obligations, it is supposed to undertake the primary task of providing financial assistance in different forms. These are something more than pure financial institutions. Development banks are viewed as financial intermediary supplying medium and long term funds to bankable economic development projects and providing related services. They are expected to mobilise large capital from other sources. Accordingly, the task of economic transformation and rapid industrialisation can best be handled only through development banks rather than through the normal process of governmental machinery. Important development or specialised financial institutions may be discussed as follows:

Industrial Finance Corporation of India (IFCI)

The IFCI is the first Development Financial Institution in India. It is a pioneer in development banking in India. It was established in 1948 under an Act of Parliament. The main objective of IFCI is to render financial assistance to large scale industrial units, particularly at a time when the ordinary banks are not forth coming to assist these concerns. Its activities include project financing, financial services, merchant banking and investment. Till 1993, IFCI continued to be Developmental Financial Institution. After 1993, it was changed from a statutory corporation to a company under the Indian Companies Act, 1956 and was named as IFCI Ltd with effect from October 1999.

Functions of IFCI

Functions of IFCI can be classified into three: (a) financial assistance (b) Promotional activities, and (c) financial Services.

(a) Financial Assistance: IFCI renders financial assistance in one or more of the following forms:

1. Guaranteeing loans raised by industrial concerns which are repayable within a period of 25 years.

2. Underwriting the issue of stock, shares, bonds or debentures by industrial concerns but must dispose of such securities within 7 years.

3. Granting loans or advances to or subscribing to debentures of industrial concerns, repayable within 25 years.

4. Acting as agent for the Central Govt. and for the World Bank in respect of loans sanctioned by them to industrial concerns.

5. Granting loans to industrial units

6. Guaranteeing deferred payments by importers of capital goods, which are able to obtain this concession from foreign manufacturers.

7. Guaranteeing loans raised by industrial concerns from scheduled banks or state co-operative banks.

8. Guaranteeing with the prior approval of the Central Govt. loans rose from any bank or financial institution in any country outside India by industrial concerns in foreign country.

(b) Promotional Activities: The IFCI has been playing a very important role as a financial institution in providing financial assistance to eligible industrial concerns. It is playing a promotional role too. It has been creating industrial opportunities. It discovers the opportunities for promoting new enterprises. It helps in developing small and medium scale entrepreneurs by providing them guidance through its specialized agencies in identification of projects, preparing project profiles, implementation of the projects etc. It acts as an instrument of accelerating the industrial growth and reducing regional industrial and income disparities.

(c) Financial Services: The following financial services are provided by IFCI.

(i) Corporate counselling for financial reconstruction

(ii) Assistance in settlement of terms and conditions with foreign collaborators.

(iii) Revival of sick units

(iv) Financing of risky projects

(v) Merchant banking services

The IFCI has promoted ICRA Ltd, a credit rating agency to help investors undertake investment decisions. It has also established Management Development Institute (MDI) with the objective of imparting training in modern management techniques to entrepreneurs, govt. officers, and people from public and private sector.

Industrial Development Bank of India (IDBI)

The IDBI was established on July 1, 1964 under an Act of Parliament. It was set up as the central co-ordinating agency, leader of development banks and principal financing institution for industrial finance in the country. Originally, IDBI was a wholly owned subsidiary of RBI. But it was delinked from RBI w.e.f. Feb. 16, 1976. IDBI is an apex institution to co-ordinate, supplement and integrate the activities of all existing specialised financial institutions. It is a refinancing and re-discounting institution operating in the capital market to refinance term loans and export credits. It is in charge of conducting techno-economic studies. It was expected to fulfil the needs of rapid industrialisation. The IDBI is empowered to finance all types of concerns engaged or to be engaged in the manufacture or processing of goods, mining, transport, generation and distribution of power etc., both in the public and private sectors.

Assistance

The composition of assistance given by IDBI may be broadly grouped as direct assistance, indirect assistance and Promotional activities. Direct Assistance: Direct assistance takes the form of loan/soft loans, underwriting/subscriptions to shares and debentures and guarantees.

Indirect Assistance: It provides assistance to tiny, small and medium enterprises indirectly by way of refinance of loans granted by SFCs, commercial banks, co-operative banks and regional rural banks, through discounting of bills of exchange arising out of the sale of indigenous machinery on deferred payment basis and seed capital assistance to new entrepreneurs through SFCs etc.

Promotional Activities: These include the following:

(a) Assistance for the development of backward areas: This is provided through direct financial assistance at concessional terms and through concessional refinance assistance to projects located in specified backward areas/districts.

(b) Assistance by way of seed capital scheme: This is to help technician entrepreneurs who have technically feasible and economically viable projects but do not have sufficient capital.

(c) A large range of consultancy services: Another promotional scheme is the setting up of TCOs with the principal idea of providing different types of consultancy services to small and medium enterprises, Government departments, commercial banks and others engaged in industrial development. It also provides assistance to voluntary agencies for

setting up of science and technology entrepreneurship parks etc., under its network of promotional activities.

In order to boost capital market as well as to play its catalyst role in development and promotional activities for the benefit of industry, IDBI has set up Small Industries Development Fund, Stockholding Cooperation of India, SEBI, National Stock Exchange of India, OTC Exchange of India, Entrepreneurship Development Institute of India, SCICI, TFCI, mutual fund and commercial bank.

Functions of IDBI

1. It co-ordinates the operation of other institutions providing term finance to industries.
2. It provides assistance to medium and large industries by way of direct finance and refinance of industrial loans.
3. It extends resource support to all India and state level financial institutions and other financial intermediaries.
4. It renders services like asset credit equipment finance, equipment leasing and bridge loans.
5. It also undertakes merchant banking.
6. It provides technical and administrative assistance to industrial concerns.
7. It guarantees deferred payments due from any industrial concern. It guarantees loans raised by industrial concerns from any financial institution.
8. It promotes and develops key industries which are necessary to meet the overall needs of the economy.
9. It undertakes techno-economic studies and surveys on its own with a view to promoting the establishment of new enterprises.

Industrial Credit and Investment Corporation of India (ICICI)

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

Objectives of ICICI

The main objective of the ICICI was to meet the needs of the industry for long term funds in the private sector. Other objectives include:

(a) To assist in the creation, expansion and modernisation of industrial enterprises in the private sector.

(b) To encourage and promote the participation of private capital, both internal and external, in such enterprises; and

(c) To encourage and promote private ownership of industrial investment and expansion of markets.

Functions of ICICI

1. It sanctions rupee loans for capital assets such as land, building, machinery etc, for long term, and foreign exchange loans for import of machinery and equipment.

2. It guarantees loans from other private investment sources.

3. It subscribes to ordinary or preference capital and underwrites new issues of securities.

4. It renders consultancy services to Indian industry in the form of managerial and technical advice.

5. It also undertakes financial services such as deferred credit, equipment leasing, instalment sale etc.

As already mentioned, the ICICI was initially created to provide finance to industrial units in the private sector only. Subsequently its scope of operations was extended to include public and joint sectors and also the co-operative projects.

It has also set up an Asset Management Company for its mutual fund. It has set up a Commercial Bank (India's first internet bank). Recently, ICICI has merged with ICICI bank.

State Level Financial Institutions

Some financial institutions are working at the state level. The important state level institutions are State Financial Corporations and State Industrial Development Corporations.

Here we discuss only SFCs.

State Finance Corporations (SFCs)

The Govt. after independence realised the need of creating a financial corporation at the state level for catering to the needs of industrial entrepreneurs. As a result, the Govt of India after consultation with the State governments and the Reserve Bank of India, introduced State Finance Corporations bill in the Parliament in 1951. SFC Act came into existence with effect from August 1, 1952. The Act permitted the State Governments. to

establish financial corporation's for the purpose of promoting industrial development in their respective states by providing financial assistance to medium and small scale industries.

Functions of State Finance Corporations

The main function of the SFCs is to provide loans to small and medium scale industries engaged in the manufacture, preservation or processing of goods, mining, hotel industry, generation or distribution of power, transportation, fishing, assembling, repairing or packaging articles with the aid of power etc.

Other functions are follows:

1. Granting loans or advances or subscribing to shares and debentures of the industrial undertaking repayable within twenty years.
2. Guaranteeing loans raised by the industrial concerns repayable within twenty years.
3. Underwriting of the shares, bonds and debentures subject to their disposal in the market within seven years.
4. Guaranteeing deferred payments for the purchase of capital goods by industrial concerns within India.
5. Providing loans for setting up new industrial units as well as for expansion and modernisation of the existing units.
6. Discounting the bills of small and medium scale industries

Kerala Financial Corporation (KFC)

KFC has been incorporated under the SFC Act 1951. It provides financial assistance for starting of new industrial units, expansion, diversification or modernisation of existing units. Assistance is also available for setting up of Tourist Hotel in tourists centres and district head quarters, for the development of industrial estates and for the purchase of vehicles for transport undertakings. Concessional terms are offered to industrial units in the backward districts and for small scale units.

Functions of Kerala Financial Corporation

1. To grant long term loans to new and existing small scale industrial units. Maximum amount of loan is Rs. 60 lakh subject to the condition that the project cost does not exceed Rs. 3 crores.
2. To underwrite shares and debentures floated in the open market.
3. To guarantee deferred payments to machinery suppliers for indigenous machinery purchased by borrowers in Kerala.

4. To guarantee the loan raised by industrial concerns in public market. ‘

5. To provide liberalised financial assistance to entrepreneurs under ‘Techno crafts Assistance Scheme’. The corporation is financing 90% of the cost of fixed assets accepted as security subject to a maximum of Rs. 5 lakhs. It gives financial assistance to professionals, Ex-servicemen technocrats, women entrepreneurs etc. It gives working capital assistance up to a certain limit to SSI units.

14.6 CAPITAL MARKET

Introduction

There are many persons or organizations that require capital. Similarly, there are several persons or organizations that have surplus capital. They want to dispose of (or invest) their surplus capital. Capital market is a meeting place of these two broad categories of persons or organizations.

Meaning and Definition of Capital Market

Capital market simply refers to a market for long term funds. It is a market for buying and selling of equity, debt and other securities. Generally, it deals with long term securities that have a maturity period of above one year.

Capital market is a vehicle through which long term finance is channelized for the various needs of industry, commerce, govt. and local authorities. According to W.H. Husband and J.C. Dockerbay, “the capital market is used to designate activities in long term credit, which is characterised mainly by securities of investment type”.

Thus, capital market may be defined as an organized mechanism for the effective and smooth transfer of money capital or financial resources from the investors to the entrepreneurs.

Characteristics of Capital Market

1. It is a vehicle through which capital flows from the investors to borrowers.

2. It generally deals with long term securities.

3. All operations in the new issues and existing securities occur in the capital market.

4. It deals in many types of financial instruments. These include equity shares, preference shares, debentures, bonds, etc. These are known as securities. It is for this reason that capital market is known as ‘Securities Market’.

5. It functions through a number of intermediaries such as banks, merchant bankers, brokers, underwriters, mutual funds etc. They serve as links between investors and borrowers.

6. The constituents (players) in the capital market include individuals and institutions. They include individual investors, investment and trust companies, banks, stock exchanges, specialized financial institutions etc.

Money market	Capital market
1. Short term funds 2. Operational/WC needs 3. Instruments are: bills, CPs, T-bills, CDs etc., 4. Huge face value for single instrument 5. Central and coml. banks are major players 6. No formal place for transactions 7. Usually no role for brokers	1. Long term funds 2. FC/PC requirements 3. Shares, debentures, bonds etc., are main instruments in capital market 4. Small face value of securities 5. Development banks, investment institutions are major players 6. Formal place, stock exchanges 7. Brokers playing a vital role

Importance of Capital Market

The importance of capital market is outlined as below:

1. Mobilisation of savings: Capital market helps in mobilizing the savings of the country. It gives an opportunity to the individual investors to employ their savings in more productive channels.

2. Capital formation: Large amount is required to invest in infrastructural foundation. Such a large amount cannot be collected from one individual or few individuals. Capital market provides an opportunity to collect funds from a large number of people who have investible surplus. In short, capital market plays a vital role in capital formation at a higher rate.

3. Economic development: With the help of capital market, idle funds of the savers are channelized to the productive sectors. In this way, capital market helps in the rapid industrialization and economic development of a country.

4. Integrates different parts of the financial system: The different components of the financial system includes new issue market, money market, stock exchange etc. It is

the capital market which helps to establish a close contact among different parts of the financial system. This is essential for the growth of an economy.

5. Promotion of stock market: A sound capital market promotes an organized stock market. Stock exchange provides for easy marketability to securities. A readymade market is available to buyers and sellers of securities.

6. Foreign capital: Multinational Corporations and foreign investors will be ready to invest in a country where there is a developed capital market. Thus capital market not only helps in raising foreign capital but the foreign technology also comes within the reach of the local people.

7. Economic welfare: Capital market facilitates increase in production and productivity in the economy. It raises the national income of the country. In this way, it helps to promote the economic welfare of the nation.

8. Innovation: Introduction of a new financial instrument, finding new sources of funds, introduction of new process etc. are some of the innovations introduced in capital market. Innovation ensures growth.

Components of Capital Market

There are four main components of capital market. They are: (a) Primary market, (b) Government Securities Market, (c) Financial Institutions, and (d)Secondary Market

These components of capital market may be discussed in detail in the following pages:

A. Primary Market /New Issue Market (NIM)

Every company needs funds. Funds may be required for short term or long term. Short term requirements of funds can be met through banks, lenders, institutions etc. When a company wishes to raise long term capital, it goes to the primary market. Primary market is an important constituent of a capital market. In the primary market the security is purchased directly from the issuer.

Meaning of Primary Market

The primary market is a market for new issues. It is also called new issue market. It is a market for fresh capital. It deals with the new securities which were not previously available to the investing public. Corporate enterprises and Govt. raises long term funds from the primary market by issuing financial securities.

Both the new companies and the existing companies can issue new securities on the primary market. It also covers raising of fresh capital by government or its agencies. The primary market comprises of all institutions dealing in fresh securities.

These securities may be in the form of equity shares, preference shares, debentures, right issues, deposits etc.

Functions of Primary Market

The main function of a primary market can be divided into three service functions. They are: origination, underwriting and distribution.

1. Origination: Origination refers to the work of investigation, analysis and processing of new project proposals. Origination begins before an issue is actually floated in the market. The function of origination is done by merchant bankers who may be commercial banks, all India financial institutions or private firms.

2. Underwriting: When a company issues shares to the public it is not sure that the whole shares will be subscribed by the public. Therefore, in order to ensure the full subscription of shares (or at least 90%) the company may underwrite its shares or debentures. The act of ensuring the sale of shares or debentures of a company even before offering to the public is called underwriting. It is a contract between a company and an underwriter (individual or firm of individuals) by which he agrees to undertake that part of shares or debentures which has not been subscribed by the public. The firms or persons who are engaged in underwriting are called underwriters.

3. Distribution: This is the function of sale of securities to ultimate investors. This service is performed by brokers and agents. They maintain a direct and regular contact with the ultimate investors.

Methods of Raising Fund in the Primary Market (Methods of Floating New Issues)

A company can raise capital from the primary market through various methods. The methods include public issues, offer for sale, private placement, right issue, and tender method.

a. Public Issues This is the most popular method of raising long term capital. It means raising funds directly from the public. Under this method, the company invites subscription from the public through the issue of prospectus (and issuing advertisements in news papers). On the basis of offer in the prospectus, the investors apply for the number of securities they are willing to take. In response to application for securities, the company makes the allotment of shares, debentures etc.

Types of Public Issues: Public issue is of two types, namely, initial public offer and follow-on public offer.

Initial Public Offering (IPO): This is an offering of either a fresh issue of securities or an offer for sale of existing securities or both by an unlisted company for the first time in its life to the public. In short, it is a method of raising securities in which a company sells shares or stock to the general public for the first time.

Follow-on Public Offering (FPO): This is an offer of sale of securities by a listed company. This is an offering of either a fresh issue of securities or an offer for sale to the public by an already listed company through an offer document.

Methods of Determination of Prices of New Shares

Equity offerings by companies are offered to the investors in two forms – (a) fixed price offer method, and (b) book building method.

Fixed Price Offer Method

In this case, the company fixes the issue price and then advertises the number of shares to be issued. If the price is very high, the investors will apply for fewer numbers of shares. On the other hand, if the issue is under-priced, the investors will apply for more number of shares. This will lead to huge over subscription.

The main steps involved in issue of shares under fixed price offer method are as follows:

1. Selection of merchant banker
2. Issue of a prospectus
3. Application for shares
4. Allotment of shares to applicants
5. Issue of Share Certificate

Book-building Method

It was introduced on the basis of recommendations of the committee constituted under the chairmanship of Y.H. Malegam in October, 1995. Under this method, the company does not price the securities in advance. Instead, it offers the investors an opportunity to bid collectively. It then uses the bids to arrive at a consensus price. All the applications received are arranged and a final offer price (known as cut off price) is arrived at. Usually the cut off price is the weighted average price at which the majority of investors are willing to buy the securities. In short, book building means selling securities to investors at an acceptable price with the help of intermediaries called

Book-runners. It involves sale of securities to the public and institutional bidders on the basis of predetermined price range or price band. The price band cannot exceed 20% of the floor price. The floor price is the minimum price at which bids can be made by the investors. It is fixed by the merchant banker in consultation with the issuing company. Thus, book building refers to the process under which pricing of the issue is left to the investors. Today most IPOs in India use book-building method. As per SEBI's guidelines 1997, the book building process may be applied to 100 per cent of the issue, if the issue size is 100 crores or more.

b. Offer for Sale Method

Under this method, instead of offering shares directly to the public by the company itself, it offers through the intermediary such as issue houses / merchant banks / investment banks or firms of stock brokers.

Under this method, the sale of securities takes place in two stages. In the first stage, the issuing company sells the shares to the intermediaries such as issue houses and brokers at an agreed price. In the second stage, the intermediaries resell the securities to the ultimate investors at a market related price. This price will be higher. The difference between the purchase price and the issue price represents profit for the intermediaries. The intermediaries are responsible for meeting various expenses. Offer for sale method is also called bought out deal. This method is not common in India.

c. Private Placement of Securities

Private placement is the issue of securities of a company direct to one investor or a small group of investors. Generally the investors are the financial institutions or other existing companies or selected private persons such as friends and relatives of promoters. A private company cannot issue a prospectus. Hence it usually raises its capital by private placement. A public limited company can also raise its capital by placing the shares privately and without inviting the public for subscription of its shares. Company law defines a privately placed issue to be the one seeking subscription from 50 members. In a private placement, no prospectus is issued. In this case the elaborate procedure required in the case of public issue is avoided. Therefore, the cost of issue is minimal. The process of raising funds is also very simple. But the number of shares that can be issued in a private placement is generally limited. Thus, private placement refers to the direct sale of newly issued securities by the issuer to a small number of investors through merchant bankers.

d. Right Issue

Right issue is a method of raising funds in the market by an existing company. Under this method, the existing company issues shares to its existing shareholders in proportion to the number of shares already held by them. Thus a right issue is the issue of new shares in which existing shareholders are given pre-emptive rights to subscribe to the new issue on a pro-rata basis. According to Section 81 (1) of the Companies Act, when the company wants to increase the subscribed capital by issue of further shares, such shares must be issued first of all to existing shareholders in proportion of their existing shareholding. The existing shareholders may accept or reject the right. Shareholders who do not wish to take up the right shares can sell their rights to another person. If the shareholders neither subscribe the shares nor transfer their rights, then the company can offer the shares to public. A company making right issue is required to send a circular to all existing shareholders. The circular should provide information on how additional funds would be used and their effect on the earning capacity of the company. The company should normally give a time limit of at least one month to two months to shareholders to exercise their rights before it is offered to the public. No new company can make right issue.

Promoters offer right issue at attractive price often at a discount to the market price due to a variety of reasons. The reasons are: (a) they want to get their issues fully subscribed to, (b) to reward their shareholders, (c) it is possible that the market price does not reflect a share's true worth or that it is overpriced, (d) to increase their stake in the companies so as to avoid preferential allotment. e. Other Methods of Issuing Securities

Apart from the above methods, there are some other methods of issuing securities. They are:

1. Tender method: Under tender method, the issue price is not predetermined. The company announces the public issue without indicating the issue price. It invites bids from various interested parties. The parties participating in the tender submit their maximum offers indicating the maximum price they are willing to pay. They should also specify the number of shares they are interested to buy. The company, after receiving various offers, may decide about the price in such a manner that the entire issue is fairly subscribed or sold to the parties participating in the tender.

2. Issue of bonus shares: Where the accumulated reserves and surplus of profits of a company are converted into paid up capital, it is called bonus issue. It simply refers to capitalization of existing reserves and surpluses of a company.

3. Offer to the employees: Now a days companies issue shares on a preferential basis to their employees (including whole time directors). This attracts, retains and motivates the employees by creating a sense of belonging and loyalty. Generally shares are issued at a discount. A company can issue shares to their employees under the following two schemes: (a) Employee stock option scheme and (b) employee stock purchase scheme.

4. Offer to the creditors: At the time of reorganization of capital, creditors may be issued shares in full settlement of their loans.

5. Offer to the customers: Public utility undertakings offer shares to their customers. Procedure of Public Issue Under public issue, the new shares/debentures may be offered either directly to the public through a prospectus (offer document) or indirectly through an offer for sale involving financial intermediaries or issue houses.

The main steps involved in public issue are as follows:

1. ***Draft Prospectus***: A draft prospectus has to be prepared giving all required information. Any company or a listed company making a public issue or a right issue of value more than Rs. 50 lakh has to file a draft offer document with SEBI for its observation. The company can proceed further after getting observations from the SEBI. The company can open its issue within 3 months from the date of SEBI's observation letter.

2. ***Fulfilment of Entry Norms***: The SEBI has laid down certain entry norms (parameters) for accessing the primary market. A company can enter into the primary market only if a company fulfils these entry norms.

3. ***Appointment of Underwriters***: Sometimes underwriters are appointed to ensure full subscription.

4. ***Appointment of Bankers***: Generally, the company shall nominate its own banker to act as collecting agent. The bankers along with their branch network process the funds procured during the public issue.

5. ***Initiating allotment procedure***: When the issue is subscribed to the minimum level, the registrars initiate the allotment procedure.

6. ***Appointment of Brokers to the issue***: Recognised members of the stock exchange are appointed as brokers to the issue.

7. ***Filing of Documents***: Documents such as draft prospectus, along with the copies of the agreements entered into with the lead manager, underwriters, bankers, Registrars, and brokers to the issue have to be filed with the Registrar of Companies.

8. ***Printing of prospectus and application forms***: After filing the above documents, the prospectus and application forms are printed and dispatched to all merchant bankers, underwriters and brokers to the issue.

9. ***Listing the issue***: It is very essential to send a letter to the stock exchange concerned where the issue is proposed to be listed.

10. ***Publication in news papers***: The next step is to publish an abridged version of the prospectus and the commencing and closing dates of issues in major English dailies and vernacular newspapers.

11. ***Allotment of shares***: After close of the issue, all application forms are scrutinised tabulated and then the shares are allotted against those applications received. Players or Participants (or Intermediaries) in the Primary market/Capital Market

There are many players (intermediaries) in the primary market (or capital market). Important players are as follows:

1. ***Merchant bankers***: In attracting public money to capital issues, merchant bankers play a vital role. They act as issue managers, lead managers or co-managers (functions in detail is given in following pages)

2. ***Registrars to the issue***: Registrars are intermediaries who undertake all activities connected with new issue management. They are appointed by the company in consultation with the merchant bankers to the issue.

3. ***Bankers***: Some commercial banks act as collecting agents and some act as co-coordinating bankers. Some bankers act as merchant bankers and some are brokers. They play an important role in transfer, transmission and safe custody of funds.

4. ***Brokers***: They act as intermediaries in purchase and sale of securities in the primary and secondary markets. They have a network of sub brokers spread throughout the length and breadth of the country.

5. ***Underwriters***: Generally investment bankers act as underwriters. They agreed to take a specified number of shares or debentures offered to the public, if the issue is not fully subscribed by the public. Underwriters may be financial institutions, banks, mutual funds, brokers etc.

Special Features of the Indian Capital Market

Indian capital market has the following special features:

1. Greater reliance on debt instruments as against equity and in particular, borrowing from financial institutions.

2. Issue of debentures specifically, convertible debentures with automatic orcompulsory conversion into equity without the normal option given to investors.

3. Floatation of Mega issues for the purpose of take over, amalgamation etc. and avoidance of borrowing from financial institutions for the fear of their discipline and conversion clause by the bigger companies, and this has now become optional.

4. Avoidance of underwriting by some companies to reduce the costs and avoid scrutiny by the FIs. It has become optional now.

5. Fast growth of mutual funds and subsidiaries of banks for financial services leading to larger mobilisation of savings from the capital market.

Defects of the Indian Primary Market

The Indian primary market has the following defects: 1. The new issue market is not able to mobilise adequate savings from the public. Only 10% of the savings of the household sector go to the primary market.

2. The merchant bankers do not play adequate attention to the technical, managerial and feasibility aspects while appraising the project proposal. In fact, they do not seem to play a development role. As a result, the small investors are duped by the companies.

3. There is inordinate delay in the allotment process. This will discourage the small investors to approach the primary market for investing their funds.

4. Generally there is a tendency on the part of the investors to prefer fixed income bearing securities like preference shares and debentures. They hesitate to invest in equity shares. There is a risk aversion in the new issue market. This stands in the way of a healthy primary market.

5. There is a functional and institutional gap in the new issue market. Awholesale market is yet to develop for new issue or primary market.

6. In the case of investors from semi-urban and rural areas, they have to incur more expenses for sending the application forms to centres where banks are authorized to accept them. The expenses in connection with this include bank charges, postal expenses and so on. All these will discourage the small investors in rural areas. Over the

years, SEBI, and Central Government have come up with a series of regulatory measures to give a boost to new issue market.

B. Government Securities Market

This is another constituent of the capital market. The govt. shall borrow funds from banks, financial institutions and the public, to finance its expenditure in excess of its revenues. One of the important sources of borrowing funds is issuing Govt. securities. Govt. securities are the instruments issued by central government, state governments, semi-government bodies, public sector corporations and financial institutions such as IDBI, IFCI, SFCs, etc. in the form of marketable debt. They comprise of dated securities issued by both central and state governments including financial institutions owned by the government. These are the debt obligations of the government. Govt. securities are also known as Gilt-edged securities. Gilt refers to gold. Thus govt. securities or gilt-edged securities are as pure as gold. This implies that these are completely risk free (no risk of default). Govt. securities market is a market where govt. securities are traded. It is the largest market in any economic system. Therefore, it is the benchmark for other market. Government securities are issues by:

- Central Government
- State Government
- Semi-Government authorities like local government authorities, e.g., city corporations and municipalities
- Autonomous institutions, such as metropolitan authorities, port trusts,development trusts, state electricity boards.
- Public Sector Corporations
- Other governmental agencies, such as SFCs, NABARD, LDBs, SIDCs, housing boards etc.

Characteristics of Gilt-edged Securities Market

a. Gilt-edged securities market is one of the oldest markets in India. The market in these securities is a significant part of Indian stock market. Main characteristics of government securities market are as follows:

b. Supply of government securities in the market arises due to their issue by the Central, State of Local governments and other semi-government and autonomous institutions explained above.

c. Government securities are also held by Reserve Bank of India (RBI) for purpose and sale of these securities and using as an important instrument of monetary control.

d. The securities issued by government organisations are government guaranteed securities and are completely safe as regards payment of interest and repayment of principal.

e. Gilt-edged securities bear a fixed rate of interest which is generally lower than interest rate on other securities.

f. These securities have a fixed maturity period.

g. Interest on government securities is payable half-yearly.

h. Subject to the limits under the Income Tax Act, interest on these securities is exempt from income tax.

i. The gilt-edged market is an 'over-the-counter' market and each sale andpurpose has to be negotiated separately.

j. The gilt-edged market is basically limited to institutional investors.

C. Financial Institutions

Financial institutions are the most active constituent of the Indian capital market. There are special financial institutions which provide medium and long term loans to big business houses. Such institutions help in promoting new companies, expansion and development of existing companies etc. The main special financial institutions of the Indian capital are IDBI, IFCI, ICICI, UTI, LIC, NIDC, SFCs etc.

New Financial Instruments in the Capital Market

With the evolution of the capital market, new financial instruments are being introduced to suit the requirements of the market. Some of the new financial instruments introduced in recent years may be briefly explained as below:

1. Floating rate bonds: The interest rate on these bonds is not fixed. It is a concept which has been introduced primarily to take care of the falling market or to provide a cushion in times of falling interest rates in the economy. It helps the issuer to hedge the loss arising due to interest rate fluctuations. Thus there is a provision to reduce interest risk and assure minimum interest on the investment. In India, SBI was the first to introduce FRB for retail investors.

2. Zero interest bonds: These carry no periodic interest payment. These are sold at a huge discount. These can be converted into equity shares or non-convertible debentures

3. Deep discount bonds: These bonds are sold at a large discount while issuing them. These are zero coupon bonds whose maturity is very high (say, 15 years). There is no interest payment. IDBI was the first financial institution to offer DDBs in 1992.

4. Auction related debentures: These are a hybrid of CPs and debentures. These are secured, redeemable, non-convertible instrument. The interest on them is determined by the market. These are placed privately with bids. ANZ Grindlays designed this new instrument for Ashok Leyland Finance.

5. Secured Premium Notes: These are issued along with a detachable warrant. This warrant gives the holder the right to apply for, or seek allotment of one equity share, provided the SPN is fully paid. The conversion of detachable warrant into equity shares is done within the time limit notified by the company. There is a lock in period during which no interest is paid for the invested amount. TISCO was the first company to issue SPN (in 1992) to the public along with the right issue.

6. Option bonds: Option bonds can be converted into equity or preference shares at the option of the investor as per the condition stated in the prospectus. These may be cumulative or non-cumulative. In case of cumulative bonds the interest is accumulated and is payable at maturity. In case of non-cumulative bonds, interest is payable at periodic intervals.

7. Warrants: A share warrant is an option to the investor to buy a specified number of equity shares at a specified price over a specified period of time. The warrant holder has to surrender the warrant and pay some cash known as 'exercise price' of the warrant to purchase the shares. On exercising the option the warrant holder becomes a shareholder. Warrant is yet to gain popularity in India, due to the complex nature of the instrument.

8. Preference shares with warrants: These carry a certain number of warrants. These warrants give the holder the right to apply for equity shares at premium at any time in one or more stages between the third and fifth year from the date of allotment.

9. Non-convertible debentures with detachable equity warrants: In this instrument, the holder is given an option to buy a specified number of shares from the company at a predetermined price within a definite time frame.

10. Zero interest fully convertible debentures: On these instruments, no interest will be paid to the holders till the lock in period. After a notified period, these debentures will be automatically and compulsorily converted into shares.

11. Fully convertible debentures with interest: This instrument carries no interest for a specified period. After this period, option is given to apply for equities at premium for which no additional amount is payable. However, interest is payable at a predetermined rate from the date of first conversion to second / final conversion and equity will be issued in lieu of interest.

12. Non-voting shares: The Companies Bill, 1997 proposed to allow companies to issue non-voting shares. These are quasi -equity instruments with differential rights. These shares do not carry voting right. Their divided rate is also not predetermined like preference shares.

13. Inverse float bonds: These bonds are the latest entrants in the Indian capital market. These are bonds carrying a floating rate of interest that is inversely related to short term interest rates.

14. Perpetual bonds: These are debt instruments having no maturity date. The investors receive a stream of interest payment for perpetuity.

In text questions

1). Define the term "Capital Market"

2). Examine the Characteristics of Capital Market

3). Distinguish between Money market and Capital market

4). State the importance of Capital Market

5). Discuss the Components of Capital Market

6). Explain the important player's vital role play in the capital market

7). Examine the special Features of the Indian Capital Market

Financial Markets

Financial markets are another part or component of financial system. Efficient financial markets are essential for speedy economic development. The vibrant financial market enhances the efficiency of capital formation. It facilitates the flow of savings into investment. Financial markets bridge one set of financial intermediaries with another set of players. Financial markets are the backbone of the economy. This is because they provide monetary support for the growth of the economy. The growth of the financial markets is the barometer of the growth of a country's economy.

Financial market deals in financial securities (or financial instruments) and financial services. Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services. These are the markets in which

money as well as monetary claims is traded in. Financial markets exist wherever financial transactions take place. Financial transactions include issue of equity stock by a company, purchase of bonds in the secondary market, deposit of money in a bank account, transfer of funds from a current account to a savings account etc. The participants in the financial markets are corporations, financial institutions, individuals and the government. These participants trade in financial products in these markets. They trade either directly or through brokers and dealers. In short, financial markets are markets that deal in financial assets and credit instruments.

Functions of Financial Markets:

The main functions of financial markets are outlined as below:

1. To facilitate creation and allocation of credit and liquidity.
2. To serve as intermediaries for mobilisation of savings.
3. To help in the process of balanced economic growth.
4. To provide financial convenience.
5. To provide information and facilitate transactions at low cost.
6. To cater to the various credits needs of the business organisations.

Classification of Financial Markets:

There are different ways of classifying financial markets. There are mainly five ways of classifying financial markets.

1. Classification on the basis of the type of financial claim: On this basis, financial markets may be classified into debt market and equity market.

Debt market: This is the financial market for fixed claims like debt instruments. Equity market: This is the financial market for residual claims, i.e., equity instruments.

2. Classification on the basis of maturity of claims: On this basis, financial markets may be classified into money market and capital market.

Money market: A market where short term funds are borrowed and lend is called money market. It deals in short term monetary assets with a maturity period of one year or less. Liquid funds as well as highly liquid securities are traded in the money market. Examples of money market are Treasury bill market, call money market, commercial bill market etc. The main participants in this market are banks, financial institutions and government. In short, money market is a place where the demand for and supply of short term funds are met.

Capital market: Capital market is the market for long term funds. This market deals in the long term claims, securities and stocks with a maturity period of more than one year. It is the market from where productive capital is raised and made available for industrial purposes. The stock market, the government bond market and derivatives market are examples of capital market. In short, the capital market deals with long term debt and stock.

3. Classification on the basis of seasoning of claim: On this basis, financial markets are classified into primary market and secondary market.

Primary market: Primary markets are those markets which deal in the newsecurities. Therefore, they are also known as new issue markets. These are markets where securities are issued for the first time. In other words, these are the markets for the securities issued directly by the companies. The primary markets mobilise savings and supply fresh or additional capital to business units. In short, primary market is a market for raising fresh capital in the form

of shares and debentures.

Secondary market: Secondary markets are those markets which deal in existing securities. Existing securities are those securities that have already been issued and are already outstanding. Secondary market consists of stock exchanges. Stock exchanges are self regulatory bodies under the overall regulatory purview of the Govt. /SEBI.

4. Classification on the basis of structure or arrangements: On this basis, financial markets can be classified into organised markets and unorganized markets. Organised markets: These are financial markets in which financial transactions take place within the well established exchanges or in the systematic and orderly structure. Unorganised markets: These are financial markets in which financial transactions take place outside the well established exchange or without systematic and orderly structure or arrangements.

5. Classification on the basis of timing of delivery: On this basis, financial markets may be classified into cash/spot market and forward / future market. Cash / Spot market: This is the market where the buying and selling of commodities happens or stocks are sold for cash and delivered immediately after the purchase or sale of commodities or securities.

Forward/Future market: This is the market where participants buy and sell stocks/commodities, contracts and the delivery of commodities or securities occurs at a pre-determined time in future.

6. Other types of financial market: Apart from the above, there are some other types of financial markets. They are foreign exchange market and derivatives market.

Foreign exchange market: Foreign exchange market is simply defined as a market in which one country's currency is traded for another country's currency. It is a market for the purchase and sale of foreign currencies.

Derivatives market: The derivatives are most modern financial instruments in hedging risk. The individuals and firms who wish to avoid or reduce risk can deal with the others who are willing to accept the risk for a price. A common place where such transactions take place is called the derivative market. It is a market in which derivatives are traded. In short, it is a market for derivatives.

The important types of derivatives are forwards, futures, options, swaps, etc.

III. Financial Instruments (Securities)

Financial instruments are the financial assets, securities and claims. They may be viewed as financial assets and financial liabilities. Financial assets represent claims for the payment of a sum of money sometime in the future (repayment of principal) and/or a periodic payment in the form of interest or dividend. Financial liabilities are the counterparts of financial assets. They represent promise to pay some portion of prospective income and wealth to others. Financial assets and liabilities arise from the basic process of financing. Some of the financial instruments are tradable/ transferable. Others are non tradable/non-transferable. Financial assets like deposits with banks, companies and post offices, insurance policies, NSCs, provident funds and pension funds are not tradable. Securities (included in financial assets) like equity shares and debentures, or government securities and bonds are tradable. Hence they are transferable. In short, financial instruments are instruments through which a company raises finance.

The financial instruments may be capital market instruments or money market instruments or hybrid instruments. The financial instruments that are used for raising capital through the capital market are known as capital market instruments. These include equity shares, preference shares, warrants, debentures and bonds. These securities have a maturity period of more than one year.

The financial instruments that are used for raising and supplying money in a short period not exceeding one year through money market are called money market instruments.

Examples are treasury bills, commercial paper, call money, short notice money, certificates of deposits, commercial bills, money market mutual funds.

Hybrid instruments are those instruments which have both the features of equity and debenture. Examples are convertible debentures, warrants etc. Financial instruments may also be classified as cash instruments and derivative instruments. Cash instruments are financial instruments whose value is determined directly by markets. Derivative instruments are financial instruments which derive their value from some other financial instrument or variable. Financial instruments can also be classified into primary instruments and secondary instruments. Primary instruments are instruments that are directly issued by the ultimate investors to the ultimate savers. For example, shares and debentures directly issued to the public. Secondary instruments are issued by the financial intermediaries to the ultimate savers. For example, UTI and mutual funds issue securities in the form of units to the public.

Characteristics of Financial Instruments

The important characteristics of financial instruments may be outlined as below:

1. Liquidity: Financial instruments provide liquidity. These can be easily and quickly converted into cash.

2. Marketing: Financial instruments facilitate easy trading on the market. They have a ready market.

3. Collateral value: Financial instruments can be pledged for getting loans.

4. Transferability: Financial instruments can be easily transferred from person to person.

5. Maturity period: The maturity period of financial instruments may be short term, medium term or long term.

6. Transaction cost: Financial instruments involve buying and selling cost. The buying and selling costs are called transaction costs. These are lower.

7. Risk: Financial instruments carry risk. This is because there is uncertainty with regard to payment of principal or interest or dividend as the case may be.

8. Future trading: Financial instruments facilitate future trading so as to cover risks due to price fluctuations, interest rate fluctuations etc.

IV. Financial Services

The development of a sophisticated and matured financial system in the country, especially after the early nineties, led to the emergence of a new sector. This new sector is known as financial services sector. Its objective is to intermediate and facilitate

financial transactions of individuals and institutional investors. The financial institutions and financial markets help the financial system through financial instruments. The financial services include all activities connected with the transformation of savings into investment. Important financial services include lease financing, hire purchase, installment payment systems, merchant banking, factoring, forfeiting etc.

Growth and Development of Indian Financial System

At the time of independence in 1947, there was no strong financial institutional mechanism in the country. The industrial sector had no access to the savings of the community. The capital market was primitive and shy. The private and unorganised sector played an important role in the provision of liquidity. On the whole, there were chaos and confusions in the financial system.

After independence, the government adopted mixed economic system. A scheme of planned economic development was evolved in 1951 with a view to achieve the broad economic and social objective. The government started creating new financial institutions to supply finance both for agricultural and industrial development. It also progressively started nationalizing some important financial institutions so that the flow of finance might be in the right direction. The following developments took place in the Indian financial system:

1. Nationalisation of financial institutions: RBI, the leader of the financial system, was established as a private institution in 1935. It was nationalized in1949. This was followed by the nationalisation of the Imperial bank of India. One of the important mile stone in the economic growth of India was the nationalisation of 245 life insurance Corporation in 1956. As a result, Life Insurance Corporation of India came into existence on 1 st September, 1956. Another important development was the nationalisation of 14 major commercial banks in 1969. In 1980, 6 more banks were nationalized. Another landmark was the nationalisation of general insurance business and setting up of General Insurance Corporation in 1972.

2. Establishment of Development Banks: Another landmark in the history of development of Indian financial system is the establishment of new financial institutions to supply institutional credit to industries. In 1949, RBI undertook a detailed study to find out the need for specialized institutions. The first development bank was established in 1948. That was Industrial Finance Corporation of India (IFCI). In 1951, Parliament passed State Financial Corporation Act. Under this Act, State Governments

could establish financial corporation's for their respective regions. The Industrial Credit and Investment Corporation of India (ICICI) were set up in 1955. It was supported by Government of India, World Bank etc. The UTI was established in 1964 as a public sector institution to collect the savings of the people and make them available for productive ventures. The Industrial Development Bank of India (IDBI) was established on 1st July 1964 as a wholly owned subsidiary of the RBI. On February 16, 1976, the IDBI was delinked from RBI. It became an independent financial institution. It co-ordinates the activities of all other financial institutions. In 1971, the IDBI and LIC jointly set up the Industrial Reconstruction Corporation of India with the main objective of reconstruction and rehabilitation of sick industrial undertakings. The IRCI was converted into a statutory corporation in March 1985 and renamed as Industrial Reconstruction Bank of India. Now its new name is Industrial Investment Bank of India (IIBI). In 1982, the Export-Import Bank of India (EXIM Bank) was set up to provide financial assistance to exporters and importers. On April 2, 1990 the Small Industries Development Bank of India (SIDBI) was set up as a wholly owned subsidiary of IDBI. The SIDBI has taken over the responsibility of administrating the Small Industries Development Fund and the National Equity Fund.

3. Establishment of Institution for Agricultural Development: In 1963, the RBI set up the Agricultural Refinance and Development Corporation (ARDC) to provide refinance support to banks to finance major development projects, minor irrigation, farm mechanization, land development etc. In order to meet credit needs of agriculture and rural sector, National Bank for Agriculture and Rural Development (NABARD) was set up in 1982. The main objective of the establishment of NABARD is to extend short term, medium term and long term finance to agriculture and allied activities.

4. Establishment of institution for housing finance: The National Housing Bank (NHB) has been set up in July 1988 as an apex institution to mobilize resources for the housing sector and to promote housing finance institutions.

5. Establishment of Stock Holding Corporation of India (SHCIL): In 1987, another institution, namely, Stock Holding Corporation of India Ltd. was set upto strengthen the stock and capital markets in India. Its main objective is to provide quick share transfer facilities, clearing services, support services etc. to investors.

6. Establishment of mutual funds and venture capital institutions: Mutual funds refer to the funds raised by financial service companies by pooling the savings of the public

and investing them in a diversified portfolio. They provide investment avenues for small investors who cannot participate in the equities of big companies.

Venture capital is a long term risk capital to finance high technology projects. The IDBI venture capital fund was set up in 1986. The ICICI and the UTI have jointly set up the Technology Development and Information Company of India Ltd. in 1988 to provide venture capital.

7. New Economic Policy of 1991: Indian financial system has undergone massive changes since the announcement of new economic policy in 1991. Liberalisation, Privatisation and Globalisation has transformed Indian economy from closed to open economy. The corporate industrial sector also has undergone changes due to delicensing of industries, financial sector reforms, capital markets reforms, disinvestment in public sector undertakings etc. Since 1990s, Government control over financial institutions has diluted in a phased manner. Public or development financial institutions have been converted into companies, allowing them to issue equity/bonds to the public. Government has allowed private sector to enter into banking and insurance sector. Foreign companies were also allowed to enter into insurance sector in India.

Weaknesses of Indian Financial System

Even though Indian financial system is more developed today, it suffers from certain weaknesses. These may be briefly stated below:

1. Lack of co-ordination among financial institutions: There are a large number of financial intermediaries. Most of the financial institutions are owned by the government. At the same time, the government is also the controlling authority of these institutions. As there is multiplicity of institutions in the Indian financial system, there is lack of co-ordination in the working of these institutions.

2. Dominance of development banks in industrial finance: The industrial financing in India today is largely through the financial institutions set up by the government. They get most of their funds from their sponsors. They act as distributive agencies only. Hence, they fail to mobilise the savings of the public. This stands in the way of growth of an efficient financial system in the country.

3. Inactive and erratic capital market: In India, the corporate customers are able to raise finance through development banks. So, they need not go to capital market. Moreover, they do not resort to capital market because it is erratic and inactive. Investors too prefer investments in physical assets to investments in financial assets.

4. Unhealthy financial practices: The dominance of development banks has developed unhealthy financial practices among corporate customers. The development banks provide most of the funds in the form of term loans. So there is a predominance of debt in the financial structure of corporate enterprises. This predominance of debt capital has made the capital structure of the borrowing enterprises uneven and lopsided. When these enterprises face financial crisis, the financial institutions permit a greater use of debt than is warranted. This will make matters worse.

5. Monopolistic market structures: In India some financial institutions are so large that they have created a monopolistic market structures in the financial system. For instance, the entire life insurance business is in the hands of LIC. The weakness of this large structure is that it could lead to inefficiency in their working or mismanagement. Ultimately, it would retard the development of the financial system of the country itself.

6. Other factors: Apart from the above, there are some other factors which put obstacles to the growth of Indian financial system. Examples are:

a. Banks and Financial Institutions have high level of NPA.

b. Government burdened with high level of domestic debt.

c. Cooperative banks are labelled with scams.

d. Investors confidence reduced in the public sector undertaking etc.,

e. Financial illiteracy.

Lesson-15

Non-Banking Financial Intermediaries

15.1 NON-BANKING FINANCIAL INSTITUTIONS (NBFIs)

The function of transferring funds from savers to investors is performed by financial intermediaries. Financial intermediaries are generally classified into two groups viz. banking institutions and NBFIs. NBFIs includes institutions such as life insurance companies, mutual funds, pension funds, chit funds etc.

A banking institution is different from non-banking institution in the following respects

- ✓ A Cheque can be issued by a banking company where as no such facility is available for NBFIs
- ✓ Commercial banks can manufacture credit (credit creation) while NBFIs cannot
- ✓ Commercial banks are able to enjoy certain facilities like rediscounting facilities, deposit insurance coverage, refinancing facilities etc. these facilities are not available for NBFIs
- ✓ Commercial banks offer/charges lesser rate of interest than that of NBFIs
- ✓ Commercial banks are subject to strict control of RBI than that of NBFIs

15.1.1 Functions of NBFIs

1.Mobilisation of savings by offering schemes to suit the needs of different classes of people.

2.Offers easy and timely credit to those are in need of it

3.Acting as financial super market by offering variety of services

4.Channelizing funds for productive purposes

5.Providing housing finance

6.These institutions, particularly, investment companies, render expert advice in investment of funds.

15.2 DISCOUNT HOUSES

Discount houses are meant for discounting bill of exchange on behalf of others. A discount house is a firm that operates in buying, selling, discounting and/or negotiating bills of exchange or promissory notes. This is usually performed on a large scale, and some of its transactions include dealing with government bonds and treasury bills.

In India, Discount and Finance House of India (DFHI) was established for this purpose. DFHI was set up in March 1988 by Reserve Bank of India jointly with public sector banks and all India Financial Institutions to develop the money market and to provide liquidity to money market instruments as a sequel to Vaghul Working Group

recommendations. With the introduction of new money market instruments such as Certificates of Deposits and Commercial Paper, DFHI began dealing in these instruments as well. With effect from 1992-93, DFHI was authorised to deal in dated Government Securities. After DFHI was accredited as a Primary Dealer in February 1996, its operations significantly increased particularly in Treasury Bills and dated Government Securities. During these years, DFHI opened its branches at Ahmedabad, Bangalore, Calcutta, Chennai, New Delhi and at Hyderabad with a view to catering to the requirements of the small and medium sized institutions operating at these centres and at the same time integrating the markets at these regional centres with main money market at Mumbai.

15.2.1 Objectives of DHFI

i. To even out the liquidity imbalances in the banking system i.e. to balance the demand with the supply for short term finance in the money market.

ii. To promote secondary market in short term money market instruments i.e. to be an active trader in money market instruments rather than a mere repository, and thereby, impart improved liquidity to short term money market instruments.

iii. To integrate markets at regional centres with the main market at Mumbai, through its network.

iv. Provide safe and risk-free short-term investment avenues to institutions; DFHI being an institution promoted by the public sector banks/financial institutions and RBI, enjoys excellent credit rating in the market.

v. Provide greater liquidity to money market instruments.

vi. Facilitate money market transactions for small and medium sized institutions who are not regular participants in the market.

vii. DFHI provides the 'Constituent SGL' Account facility which enables even those entities which otherwise do not have an SGL Account facility with the RBI to reap the full benefits of investing in government securities.

DFHI deals in the following instruments/products:

i. Treasury Bills

ii. Dated Government Securities

iii. Certificates of Deposit

iv. Commercial Papers

v. Call (overnight) Money

vi. Notice Money

vii. Term Money

viii. Derivative Usance Promissory Notes of Commercial Banks

ix. Interest Rate Swaps/Forward Rate Agreements

15.3 ACCEPTANCE HOUSES

Acceptance houses are another constituent of money market. They work in bill market. They function as an intermediary between lenders and borrowers, exporters and importers in the short term. They accept the bills of buyers whose position is unknown to sellers and thus facilitates transaction between them, for a reward of commission.

In India commercial banks are also acting as Acceptance Houses

15.4 COMMERCIAL BANKING

Evolution of Banking (Origin and development of Banking) The evolution of banking can be traced back to the early times of human history. The history of banking begins with the first prototype banks of merchants of the ancient world, which made grain loans to farmers and traders who carried goods between cities. This began around 2000 BC in Assyria and Babylonia. In olden times people deposited their money and valuables at temples, as they are the safest place available at that time. The practice of storing precious metals at safe places and loaning money was prevalent in ancient Rome. However modern Banking is of recent origin. The development of banking from the traditional lines to the modern structure passes through Merchant bankers, Goldsmiths, Money lenders and Private banks. Merchant Bankers were originally traders in goods. Gradually they started to finance trade and then become bankers. Goldsmiths are considered as the men of honesty, integrity and reliability. They provided strong iron safe for keeping valuables and money. They issued deposit receipts (Promissory notes) to people when they deposit money and valuables with them. The goldsmith paid interest on these deposits. Apart from accepting deposits, Goldsmiths began to lend a part of money deposited with them. Then they became bankers who perform both the basic banking functions such as accepting deposit and lending money. Money lenders were gradually replaced by private banks. Private banks were established in a more organised manner. The growth of Joint stock commercial banking was started only after the enactment of Banking Act 1833 in England.

15.4.1 Evolution and Growth of banking in India

India has a long history of financial intermediation. The first bank in India to be set up on modern lines was in 1770 by a British Agency House. The earliest but short-lived attempt to establish a central bank was in 1773. India was also a forerunner in terms of development of

financial markets. In the beginning of 18th century, British East India Company launched a few commercial banks. Bank of Hindustan (1770) was the first Indian bank established in India. Later on, the East India Company started three presidency banks, Bank of Bengal(1806), Bank of Bombay(1840) and Bank of Madras(1843) These bank were given the right to issue notes in their respective regions. Allahabad bank was established in 1865 and Alliance Bank in 1875. The first bank of limited liability managed by Indians was Oudh Commercial Bank founded in 1881. Subsequently, the Punjab National Bank was established in 1894. In the Beginning of the 20th century, Swadeshi movement encouraged Indian entrepreneurs to start many new banks in India. Another landmark in the history of Indian banking was the formation of Imperial bank of India in 1921 by amalgamating 3 presidency banks It is the Imperial Bank which performed some central banking functions in India. A number of banks failed during the first half of the 20 th Century. It affected the people's belief and faith in Banks.

By independence, India had a fairly well developed commercial banking system inexistence. In 1951, there were 566 private commercial banks in India with 4,151 branches, the overwhelming majority of which were confined to larger towns and cities. Savings in the form of bank deposits accounted for less that 1 per cent of national income, forming around 12 per cent of the estimated saving of the household sector. The Reserve Bank of India (RBI) was originally established in 1935 by an Act promulgated by the Government of India, but as a shareholder institution like the Bank of England. After India's independence, in the context of the need for close integration between its policies and those of the Government, the Reserve Bank became a state owned institution from January 1, 1949. It was during this year that the Banking Regulation Act was enacted to provide a framework for regulation and supervision of commercial banking activity.

By independence, India had a fairly well developed commercial banking system in existence. Reserve bank of India was nationalized in the year 1949. The enactment of the Banking Companies Act 1949 (Later it was renamed as Banking Regulation Act) was a bold step in the history of banking in India. In 1955, Imperial Bank of India was nationalized and renamed as State bank of India(SBI). The SBI started number of branches in urban and rural areas of the country.

In 1967, Government introduced the concept of social control on banking sector. Nationalization of 14 commercial banks in 1969 was a revolution in the history of banking in India. Six more commercial banks were nationalized in 1980. Other

landmarks in the history of Indian banking were the establishment of National Bank for Agricultural and Rural Development (1988), merger of New Bank of India with Punjab National Bank (1993), merger of State Bank of Sourashtra with SBI (2008) and the merger of State Bank of Indore with SBI (2010).

At present, there are 26 Public sector banks, 21 private sector banks, 32 Foreign banks and 82 Regional Rural Banks in India.

IV. Non-Banking Financial Corporation (NBFC)

Financial intermediaries are that institution which link lenders and borrows. The process of transferring saving from savers to investors is known as financial intermediation. Commercial banks and cooperative credit societies are called "finance corporations", or "finance companies". These finance companies with very little capital have been mobilizing deposits by offering attractive interest rates and incentives and advance loans to wholesale and retail traders, small industries and self-employed persons. They grant unsecured loans at very rates of interest. These are non-banking companies performing the functions of financial intermediaries. They cannot be called banks.

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares, securities, leasing, hire-purchase, insurance business, and chit business.

Number of Non-Banking Financial Corporations

The number of Non-Banking Financial Corporations continued to grow year after year in the nineties. During 1996-97, the aggregate deposits of 13,970 Non-Banking Financial Corporations totalled up to Rs.3,57,150 crores. As on March 31, 2012 the total number of Non-Banking Financial Corporations registered with RBI stood at 12,385 compared with 12,409 in 2011. The number of deposit taking Non-Banking Financial Corporation's (NBFC-D), including residuary NBFCs (RNBC), also reduced from 297 at end-March 2011 to 271 as on end March 2012. The size of total assets of Non-Banking Financial Corporations grew from Rs 1,169 billion to Rs 1,244 billion as at end March 2012. Net owned funds of NBFCs too grew 25% from Rs 180 billion in 2011 to Rs 225 billion at end March 2012.The large finance companies numbering 2,376 accounted for 63 per cent of deposits.

Functions of Non-Banking Financial Corporations:

The functions performed by Non-Banking Financial Corporations may be described as under:

• They are able to attract deposits of huge amounts by offering attractive rates of interest and other incentives. Half of the deposits are below two years time period.

•They provide loans to wholesale and retail merchants' small industries, self employment schemes.

• They provide loans without security also. Hence they are able to charge 24 to 36 per cent interest rate.

• They run Chit Funds, discount hundies, provide hire-purchase, leasing finance, merchant banking activities.

• They ventures to provide loans to enterprises with high risks. So they are able to charge high rate of interest. They renew short period loans from time to time. They therefore become long period loans.

• They are able to attract deposits by offering very high rate of interest. In the process many companies sustained losses and went into liquidation. The bankruptcy of many companies adversely affected middle-class and lower income people. There is no insurance protection for deposits as in the case of bank deposits.

• The finance companies are able to fill credit gaps by providing lease finance, hire purchase and instalment buying. They provide loans to buy scooter, cars, TVs and other consumer durables. Such extension of functions makes them almost commercial banks. The only difference is that Non-Banking Financial Corporations cannot introduce cheque system. This is the difference b/w the two

Difference between banks & Non-Banking Financial Corporations:

Non-Banking Financial Corporations are doing functions similar to that of banks; however there are a few differences:

1) A Non-Banking Financial Corporations cannot accept demand deposits,

2) It is not a part of the payment and settlement system and as such cannot issue cheques to its customers,

3) Deposit insurance facility of DICGC is not available for Non-Banking Financial Corporations depositors unlike in case of banks

Different types of Non-Banking Financial Corporations:

There are different categories of Non-Banking Financial Corporations 's operating in India under the supervisory control of RBI. They are:

1. Non-Banking Financial Companies (NBFCs)

2. Residuary Non-banking Finance companies (RNBCs).

3. Miscellaneous Non-Banking Finance Companies (MNBCs)

Residuary Non-Banking Company is a class of Non-Banking Financial Corporations, which is a company and has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner and not being Investment, Leasing, Hire-Purchase, Loan Company. These companies are required to maintain investments as per directions of RBI, in addition to liquid assets. The functioning of these companies is different from those of NBFCs in terms of method of mobilization of deposits and requirement of deployment of depositors' funds. Peerless Financial Company is the example of RNBCs.

Miscellaneous Non-Banking Financial Companies are another type of Non Banking Financial Corporations and MNBC means a company carrying on all or any of the types of business as collecting, managing, conducting or supervising as a promoter or in any other capacity, conducting any other form of chit or kuri which is different from the type of business mentioned above and any other business similar to the business as referred above.

Type of Services provided by Non-Banking Financial Corporations:

Non-Banking Financial Corporations provide range of financial services to their clients. Types of services under non-banking finance services include the following:

1. Hire Purchase Services
2. Leasing Services
3. Housing Finance Services
4. Asset Management Services
5. Venture Capital Services
6. Mutual Benefit Finance Services (Nidhi) banks.

The above type of companies may be further classified into those accepting deposits or those not accepting deposits.

1. Hire Purchase Services

Hire purchase the legal term for a conditional sale contract with an intention to finance consumers towards vehicles, white goods etc. If a buyer cannot afford to pay the price as a lump sum but can afford to pay a percentage as a deposit, the contract allows the buyer to hire the goods for a monthly rent. If the buyer defaults in paying the instalments, the owner can repossess the goods. Hire purchase is a different form of credit system among other unsecured consumer credit systems and benefits. Hero Honda Motor

Finance Co., Bajaj Auto Finance Company is some of the Hire purchase financing companies.

2. Leasing Services

A lease or tenancy is a contract that transfers the right to possess specific property. Leasing service includes the leasing of assets to other companies either on operating lease or finance lease. An NBFC may obtain license to commence leasing services subject to, they shall not hold, deal or trade in real estate business and shall not fix the period of lease for less than 3 years in the case of any finance lease agreement except in case of computers and other IT accessories. First Century Leasing Company Ltd., Sundaram Finance Ltd. Is some of the Leasing companies in India.

3. Housing Finance Services

Housing Finance Services means financial services related to development and construction of residential and commercial properties. An Housing Finance Company approved by the National Housing Bank may undertake the services/activities such as Providing long term finance for the purpose of constructing, purchasing or renovating any property, Managing public or private sector projects in the housing and urban development sector and Financing against existing property by way of mortgage. ICICI Home Finance Ltd., LIC Housing Finance Co. Ltd., HDFC is some of the housing finance companies in ourcountry.

4. Asset Management Company

Asset Management Company is managing and investing the pooled funds of retail investors in securities in line with the stated investment objectives and provides more diversification, liquidity, and professional management service to the individual investors. Mutual Funds are comes under this category. Most of the financial institutions having their subsidiaries as Asset Management Company like SBI, BOB, UTI and many others.

5. Venture Capital Companies

Venture capital Finance is a unique form of financing activity that is undertaken on the belief of high-risk-high-return. Venture capitalists invest in those risky projects or companies (ventures) that have success potential and could promise sufficient return to justify such gamble. Venture capitalist not only provides finance but also often provides managerial or technical expertise to venture projects. In India, venture capitals concentrate on seed capital finance for high technology and for research &

development. Industrial Credit and Investment corporation ventures and Gujarat Venture are one of the first venture capital organizations in India and SIDBI, Industrial development bank of India and others also promoting venture capital finance activities.

6. Mutual Benefit Finance Companies (MBFC's)

A mutual fund is a financial intermediary that allows a group of investors to pool their money together with a predetermined investment objective. The mutual fund will have a fund manager who is responsible for investing the pooled money into specific securities/bonds. Mutual funds are one of the best investments ever created because they are very cost efficient and very easy to invest in. By pooling money together in a mutual fund, investors can purchase stocks or bonds with much lower trading costs than if they tried to do it on their own. But the biggest advantage to mutual funds is diversification. There are two main types of such funds, open-ended fund and close-ended mutual funds. In case of open-ended fund, the fund manager continuously allows investors to join or leave the fund. The fund is set up as a trust, with an independent trustee, who keeps custody over the assets of the trust. Each share of the trust is called a Unit and the fund itself is called a Mutual Fund. The portfolio of investments of the Mutual Fund is normally evaluated daily by the fund manager on the basis of prevailing market prices of the securities in the portfolio and this will be divided by the number of units issued to determine the Net Asset Value (NAV) per unit. An investor can join or leave the fund on the basis of the NAV per unit. In contrast, a close-end fund is similar to a listed company with respect to its share capital. These shares are not redeemable and are traded in the stock exchange like any other listed securities. Value of units of close-end funds is determined by market forces and is available at 20-30% discount to their NAV.

Lesson-16

Role of Stock Exchanges

16.1 Secondary Market

The investors want liquidity for their investments. When they need cash, they should be able to sell the securities they hold. Similarly there are others who want to invest in new securities. There should be a place where securities of different companies can be bought and sold. Secondary market provides such a place.

16.2 Meaning of Secondary Market

Secondary market is a market for old issues. It deals with the buying and selling existing securities i.e. securities already issued. In other words, securities already issued in the primary market are traded in the secondary market. Secondary market is also known as stock market. The secondary market operates through 'stock exchanges'. In the secondary market, the existing owner sells securities to anotherparty. The secondary markets support the primary markets. The secondary market provides liquidity to the individuals who acquired these securities. Theprimary market gets benefits greatly from the liquidity provided by the secondary market. This is because investors would hesitate to buy the securities in the primary market if they thought they could not sell them in the secondary market later. In India, stock market consists of recognised stock exchanges. In the stock exchanges, securities issued by the central and state governments, public bodies, and joint stock companies are traded.

16.3 Stock Exchange

In India the first organized stock exchange was Bombay Stock Exchange. It was started in 1877. Later on, the Ahmadabad Stock Exchange and Calcutta Stock Exchange were started in 1894 and 1908 respectively. At present there are 24 stock exchanges in India. In Europe, stock exchanges are often called bourses.

16.3.1 Meaning and Definition of Stock Exchange/ Security Exchange

It is an organized market for the purchase and sale of securities of joint stock companies, government and semi-govt. bodies. It is the centre where shares, debentures and govt. securities are bought and sold. According to Pyle,"Security exchanges are market places where securities that have been listed thereon may be bought and sold for either investment or speculation"

The Securities Contract (Regulation) Act 1956, defines a stock exchange as "an association, organisation or body of individuals whether incorporated or not established for the purpose of assisting, regulating and controlling of business in buying, selling and dealing in securities". According to Hartley Withers,"a stock exchange is something like a vast warehouse where securities are taken away from the shelves and sold across the countries at a price fixed in a catalogue which is called the official list". In short, stock exchange is a place or market where the listed securities are bought and sold.

16.3.2 Characteristics of a Stock Exchange

1.It is an organized capital market.

2.It may be incorporated or non-incorporated body (association or body of individuals).

3.It is an open market for the purchase and sale of securities.

4.Only listed securities can be dealt on a stock exchange.

5.It works under established rules and regulations.

6.The securities are bought and sold either for investment or for speculative purpose.

16.3.3 Economic Functions of Stock Exchange

The Stock Exchange performs the following essential economic functions:

1.Ensures liquidity to capital: The stock exchange provides a place where shares and stocks are converted into cash. People with surplus cash can invest in securities (by buying securities) and people with deficit cash can sell their securities to convert them into cash.

2. Continuous market for Securities: It provides a continuous and ready market for buying and selling securities. It provides a ready market for those who wish to buy and sell securities

3.Mobilisation of Savings: It helps in mobilizing savings and surplus funds of individuals, firms and other institutions. It directs the flow of capital in the most profitable channel.

4. Capital formation: The stock exchange publishes the correct prices of various securities. Thus the people will invest in those securities which yield higher returns. It promotes the habit of saving and investment among the public. In this way the stock exchange facilitates the capital formation in the country.

5.Evaluation of securities: The prices at which transactions take place are recorded and made public in the forms of market quotations. From the price quotations, the investors can evaluate the worth of their holdings.

6.Economic developments: It promotes industrial growth and economic development of the country by encouraging industrial investments. New and existing concerns raise their capital through stock exchanges.

7.Safeguards for investors: Investors' interests are very much protected by the stock exchange. The brokers have to transact their business strictly according tothe rules prescribed by the stock exchange. Hence they cannot overcharge the investors.

8.Barometer of economic conditions: Stock exchange reflects the changes taking place in the country's economy. Just as the weather clock tells us which way the wind is blowing, in the same way stock exchange serves as an indicator of the phases in business cycle -boom, depression, recessions and recovery.

9.Platform for public debt: The govt. has to raise huge funds for the development activities. Stock exchange acts as markets of govt. securities. Thus, stock exchange provides a platform for raising public debt.

10. Helps to banks: Stock exchange helps the banks to maintain liquidity by increasing the volume of easily marketable securities.

11. Pricing of securities: New issues of outstanding securities in the primary market are based on the prices in the stock exchange. Thus, it helps in pricing of securities. Thus stock exchange is of great importance to a country. It provides necessary mobility to capital. It directs the flow of capital into profitable and successful enterprises. It is indispensable for the proper functioning of corporate enterprises. Without stock exchange, even govt. would find it difficult to borrow for its various schemes. It helps the traders, investors, industrialists and the banker. Hence, it is described as the business of business.

16.4 Benefits of Stock Exchange

A. Benefits to Investors

1. The stock exchange plays the role of a friend, philosopher and guide to investors by providing information about the prices of various securities.

2. It offers a ready market for buying and selling securities.

3. It increases the liquidity of the investors.

4. It safeguards the interests of investors through strict rules and regulations.

5. It enables the investors to know the present worth of their securities.

6. It helps investors in making wise investment decisions by providing useful information about the financial position of the companies.

7. The holder of a listed security can easily raise loan by pledging it as a collateral security.

B. Benefits to Companies

1. A company enjoys greater reputation and credit in the market. Image of the company goes up.

2. A company can raise large amount of capital from different types of securities.

3. It enjoys market for its shares.

4. The market price for shares and debentures will be higher. Due to this the bargaining power of the company increases in the events of merger oramalgamation.

C. Benefits to Community and Nation

1. Stock exchange encourages people to sell and invest their savings in shares and debentures.

2. Through capital formation, stock exchange enables companies to undertake expansion and modernization. Stock exchange is an 'Alibaba Cave' from which business community draw unlimited money.

3. It helps the government in raising funds through sale of government securities.This enables the government to undertake projects of national importance and social value.

4. It diverts the savings towards productive channels.

5. It helps in better utilisation of the country's financial resources.

6. It is an effective indicator of general economic conditions of a country.

16.5 Listing of Securities

A stock exchange does not deal in the securities of all companies. Only those securities that are listed are dealt with the stock exchange. For the purpose of listing of securities, a company has to apply to the stock exchange. The stock exchange will decide whether to list the securities of the company or not. If permission is granted by the stock exchange to deal with the securities therein, then such a company is included in the official trade list of the stock exchange.

This is technically known as listing of securities. Thus listing of securities means permission to quote shares and debentures officially on the trading floor of the stock exchange. Listing of securities refers to the sanction of the right to trade the securities on the stock exchange. In short, listing means admission of securities to be traded on the stock exchange. If the securities are not listed, they are not allowed to be traded on the stock exchange.

16.7 Objectives of Listing

The main objectives of listing are:

1.To ensure proper supervision and control of dealings in securities.

2.To protect the interests of shareholders and the investors.

3.To avoid concentration of economic power.

4.To assure marketing facilities for the securities.

5.To ensure liquidity of securities.

6.To regulate dealings in securities.

16.8 Advantages of Listing

A. Advantages to Company:-

1. It provides continuous market for securities (securities include shares,debentures, bonds etc.)

2. It enhances liquidity of securities.

3. It enhances prestige of the company.

4. It ensures wide publicity.

5. Raising of capital becomes easy.

6. It gives some tax advantage to the company.

B. Advantages to Investors:-

1. It provides safety of dealings.

2. It facilitates quick disposal of securities in times of need. This means that listing enhances the liquidity of securities.

3. It gives some tax advantage to the security holder.

4. Listed securities command higher collateral value for the purpose of bank loans.

5. It provides an indirect check against manipulation by the management.

Disadvantages of Listing

1. It leads to speculation

2. Sometimes listed securities are subjected to wide fluctuations in their value. This may degrade the company's reputation.

3. It discloses vital information such as dividends and bonus declared etc. to competitors.

4. Company has to spend heavily in the process of placing the securities with public

Classification of Listed Securities

The listed shares are generally divided into two categories-

Group A shares (cleared securities) and Group B shares (non-cleared securities).

Group A shares represent large and well established companies having a broad investor base. These shares are actively traded. Forward trading is allowed in Group A shares. These facilities are not available to Group B shares. These are not actively traded. Carry forward facility is not available in case of these securities.

Requirements of Listing (Procedure of Listing)

Any company intending to get its securities listed at an exchange has to fulfil certain requirements. The application for listing is to be made in the prescribed form. It should be supported by the following documents:

a) Memorandum and Articles.

b) Copies of all prospectuses or statements in lieu of prospectuses.

c) Copies of balance sheets, audited accounts, agreements with promoters, underwriters, brokers etc.

d) Letters of consent from SEBI.

e) Details of shares and debentures issued and shares forfeited.

f) Details of bonus issues and dividends declared.

g) History of the company in brief.

h) Agreement with managing director etc.

i) An undertaking regarding compliance with the provisions of the Companies Act and Securities Contracts (Regulation) Act as well as rules made therein.

After the application is made to the stock exchange the listing committee of the stock exchange will go into the details of the application. It has to ensure that the company fulfils the conditions or criteria necessary for listing

Procedure for Dealing at Stock Exchange (Trading Mechanism or Method of Trading on a Stock Exchange)

Outsiders are not allowed to buy or sell securities at a stock exchange. They have to approach brokers. Dealings can be done only through brokers. They are the members of the stock exchange. The following procedure is followed for dealing at exchanges:

1. Selection of a broker : An individual cannot buy or sell securities directly at stock exchange. He can do so only through a broker. So he has to select a broker through whom the purchase or sale is to be made. The intending investor or seller may appoint his bank for this purpose. The bank may help to choose the broker.

2. Placing an order: After selecting the broker, the next step is to place an order for purchase or sale of securities. The broker also guides the client about the type of securities to be purchased and the proper time for it. If a client is to sell the securities, then the broker shall tell him about the favourable time for sale.

3. Making the contract: The trading floor of the stock exchange is divided into different parts known as trading posts. Different posts deal in different types of securities. The authorised clerk of the broker goes to the concerned post and expresses his intention to buy and sell the securities. A deal is struck when the other party also agrees. The bargain is noted by both the parties in their note books. As soon as order is executed a confirmation memo is prepared and is given to the client.

4. Contract Note : After issue of confirmation memo, a contract note is signed between the broker and the client. This contract note will state the transaction fees (commission of broker), number of shares bought or sold, price at which they are bought or sold, etc.

5. Settlement: Settlement involves making payment to sellers of shares and delivery of share certificate to the buyer of shares after receiving the price. The settlement procedure depends upon the nature of the transactions. All the transactions on the stock exchange may be classified into two -ready delivery contracts and forward delivery contracts.

a. Ready delivery contract: A ready delivery contract involves the actual payment of the amount by the buyer in cash and the delivery of securities by the seller. A ready delivery contract is to be settled on the same day or within the time period fixed by the stock exchange authorities.

b. Forward delivery contracts: These contracts are entered into without any intention of taking and giving delivery of the securities. The traders in forward delivery

securities are interested in profits out of price variations in the future. Such transactions are settled on the settlement days fixed by the stock exchange authorities. Such contracts can be postponed to the next settlement day, if both the parties agree between themselves. Such postponement is called 'Carry over' or 'badla'. Thus 'carry over' or 'badla' means the postponement of transaction from one settlement period to the next settlement period.

16.9 Rolling Settlement

Rolling settlement has been introduced in the place of account period settlement. Rolling settlement system was introduced by SEBI in January 1998.Under this system of settlement, the trades executed on a certain day are settled based on the net obligations for that day. At present, the trades relating to the rolling settlement are settled on T + 2day basis where T stands for the trade day. It implies that the trades executed on the first day (say on Monday) have to be settled on the 3rd day (on Wednesday), i.e., after a gap of 2 days.

This cycle would be rolling and hence there would be number of set of transactions for delivery every day. As each day's transaction are settled in full,rolling settlement helps in increasing the liquidity in the market. With effect from January 2, 2002, all scrips have been brought under compulsory rolling mode.

16.10 Members in a Stock Exchange

Only members of the exchange are allowed to do business of buying and selling of securities at the floor of the stock exchange. A non-member (client) can buy and sell securities only through a broker who is a member of the stock exchange. To deal in securities on recognised stock exchanges, the broker should register his name as a broker with the SEBI.

Brokers are the main players in the secondary market. They may act in different capacities as a principal, a s an agent, as a speculator and so on.

16.11 Types of Members in a Stock Exchange

The various types of members of a stock exchange are as follows:-

1. Jobbers:-They are dealers in securities in a stock exchange. They cannot deal on behalf of public. They purchase and sell securities on their own names. Their main job is to earn profit due to price variations.

2. Commission brokers :-They are nothing but brokers. They buy and sell securities no behalf of their clients for a commission. They are permitted to deal with non-members directly. They do not purchase or sell in their own name.

3. Tarawaniwalas:-They are like jobbers. They handle transactions on a commission basis for their brokers. They buy and sell securities on their own account and may act as brokers on behalf of the public.

4. Sub-brokers:-Sub brokers are agents of stock brokers. They are employed by brokers to obtain business. They cannot carry on business in their own name. They are also known as remisiers.

5. Arbitrageurs:-They are brokers. They buy security in one market and sell the same in another market to get opportunistic profit.

6. Authorised clerks:-Authorised clerks are those who are appointed by stock brokers to assist them in the business of securities trading.

Speculation

Speculation is an attempt to make capital gain from the price movement of the scrips in the security market over a short span of time. Those who engaged in such type of transactions are called speculators. They buy and sell securities frequently and are not interested in keeping them for long term. Speculation involves high risks. If the expectation of speculators comes true he can make profit but if it goes wrong the loss could be detrimental.

Type of Speculators

The following on the different kinds of speculators:

1. Bull: A bull or Tejiwala is a speculator who buys shares in expectation of selling them at higher prices in future. He believes that current prices are lower and will rise in the future.

2. Bear: A bear or Mandiwala is a speculator who sells securities with the intention to buy at a later date at a lower price. He expects a fall in price in future.

3. Lameduck: A lame duck is a bear speculator. He finds it difficult to meet his commitments and struggles like a lame duck. This happens because of the non-availability of securities in the market which he has agreed to sell and at the same time the other party is not willing to postpone the transaction.

4. Stag: Stag is a member who neither buys nor sells securities. He applies for shares in the new issue market. He expects that the price of shares will soon increase and the shares can be sold for a premium.

5. Wolf: Wolf is a broker who is fast speculator. He is very quick to perceive changes in the market trends and trade fast and make fast profit.

16.12 Speculative Transactions

Some of the speculative dealings are as follows:

1. Option deals: This is an arrangement or right to buy or sell securities at a predetermined price on or before a specified date in future.

2. Wash sales: It is a device through which a speculator is able to reap huge profits by creating a misleading picture in the market. It is a kind of fictitious transaction in which a speculator sells a security and then buys the same at a higher price through another broker. Thus he creates a false or misleading opinion in the market about the price of a security.

3. Rigging: If refers to the process of creating an artificial condition in the market whereby the market value of a particular security is pushed upon. Bulls buy securities, create demand for the same and sell them at increased prices.

4. Arbitrage: It is the process of buying a security, from a market where price is lower and selling at in another market where price is higher.

5. Cornering: Sometimes speculators make entire or a major share of supply of a particular security with a view to create a scarcity against the existing contracts. This is called cornering.

6. Blank transfer: When the transferor (seller) simply signs the transfer form without specifying the name of the transferee (buyer), it is called blank transfer. In this case share can further be transferred by mere delivery of transfer deed together with the share certificate. A new transfer deed is not required at the time of each transfer. Hence, expenses such as registration fees, stamp duty, etc can be saved.

7. Margin trading: Under this method, the client opens an account with his broker. The client makes a deposit of cash or securities in this account. He also agrees to maintain a minimum margin of amount always in his account. When a broker purchases securities on behalf of his client, his account (client's account) will be debited and vice versa. The debit balance, if any, is automatically secured by the client's securities lying with the broker. In case it falls short of the minimum agreed amount, the client has to deposit further

amount into his account or he has to deposit further securities. If the prices are favourable, the client may instruct his broker to sell the securities. When such securities are sold, his account will be credited. The client may have a bigger margin now for further purchases.

Factors Influencing Prices on Stock Exchange

The prices on stock exchange depend upon the following factors:

1. Financial position of the company
2. Demand and supply position
3. Lending rates
4. Attitudes of the FIIs and the developments in the global financial markets.
5. Govt. Policies (credit policies, monetary policies, taxation policies etc.)
6. Trade cycle
7. Speculation activities

Defects of Stock Exchanges (or Capital Market) in India

The Indian stock market is suffering from a number of weaknesses.

Important weaknesses are as follows:

1. Speculative activities: Most of the transactions in stock exchange are carry forward transactions with a speculative motive of deriving benefit from short term price fluctuation. Genuine transactions are only less. Hence market is not subject to free interplay of demand and supply for securities.

2. Insider trading :Insider trading has been a routine practice in India. Insiders are those who have access to unpublished price-sensitive information. By virtue of their position in the company they use such information for their own benefits.

3. Poor liquidity: The Indian stock exchanges suffer from poor liquidity. Though there are approximately 8000 listed companies in India, the securities of only a few companies are actively traded. Only those securities are liquid. This means other stocks have very low liquidity.

4 Less floating securities: There is scarcity of floating securities in the Indian stock exchanges. Out of the total stocks, only a small portion is being offered for sale. The financial institutions and joint stock companies control over 75% of the scrips. However, they do not offer their holdings for sale. The UTI, GIC, LIC etc. indulge more in purchasing than in selling. This creates scarcity of stocks for trading. Hence, the market becomes highly volatile. It is subject to easy price manipulations.

5. Lack of transparency: Many brokers are violating the regulations with a view to cheating the innocent investing community. No information is available to investors regarding the volume of transactions carried out at the highest and lowest prices. In short, there is no transparency in dealings in stock exchanges.

6. High volatility: The Indian stock market is subject to high volatility in recent years. The stock prices fluctuate from hour to hour. High volatility is not conducive for the smooth functioning of the stock market.

7. Dominance of financial institutions: The Indian stock market is being dominated by few financial institutions like UTI, LIC, GIC etc. This means these few institutions can influence stock market greatly. This actually reduces the level of competition in the stock market. This is not a healthy trend for the growth of any stock market.

8. Competition of merchant bankers: The increasing number of merchant bankers in the stock market has led to unhealthy competition in the stock market. The merchant bankers help the unscrupulous promoters to raise funds for non- existent projects. Investors are the ultimate sufferers.

9. Lack of professionalism: Some of the brokers are highly competent and professional. At the same time, majority of the brokers are not so professional.They lack proper education, business skills, infrastructure facilities etc. Hence they are not able to provide proper service to their clients.

Primary Market	Secondary Market
1. It is a market for new securities. 2. It is directly promotes capital formation. 3. Investors can only buy securities. They cannot sell them. 4. There is no fixed geographical location. 5. Securities need not be listed.	1. It is a market for existing or second hand securities 2. It is directly promotes capital formation. 3. Both buying and selling of securities takes place 4. There is a fixed geographical location (stock exchanges) 5. Only listed securities can be bought and sold

6. It enables the borrowers to raise capital	6. It enables the investors to invest money in securities and sell and encash as they need money

Major Stock Exchanges in India

At present there are 24 recognised stock exchanges in India. Further OTCEI, NSE also has started functioning in our country. Brief descriptions of major SEs are given below:

1. Bombay Stock Exchange (BSE) BSE is the leading and the oldest stock exchange in India as well as in Asia. It was established in 1887 with the formation of "The Native Share and Stock Brokers' Association". BSE is a very active stock exchange with highest number of listed securities in India. Nearly 70% to 80% of all transactions in the India are done alone in BSE. Companies traded on BSE were 3,049 by March, 2006. BSE is now a national stock exchange as the BSE has started allowing its members to set-up computer terminals outside the city of Mumbai (former Bombay). It is the only stock exchange in India which is given permanent recognition by the government.

In 2005, BSE was given the status of a fully fledged public limited company along with a new name as "Bombay Stock Exchange Limited". The BSE has computerized its trading system by introducing BOLT (Bombay on Line Trading) since March 1995. BSE is operating BOLT at 275 cities with 5 lakh (0.5 million)traders a day. Average daily turnover of BSE is near Rs. 200 crores. Some facts about BSE are:

- BSE exchange was the first in India to launch Equity Derivatives, Free Float Index, USD adaptation of BSE Sensex and Exchange facilitated Internet buying and selling policy.
- BSE exchange was the first in India to acquire the ISO authorization for supervision, clearance & Settlement
- BSE exchange was the first in India to have launched private service for economic training
- Its On-Line Trading System has been felicitated by the internationally renowned standard of Information Security Management System.

Bombay Online Trading System (BOLT)

BSE online trading was established in 1995 and is the first exchange to be set up in Asia. It has the largest number of listed companies in the world and currently has

4937 companies listed on the Exchange with over 7,700 traded instruments. The only thing that an investor requires for online trading through BSE is an online trading account. The trading can then be done within the trading hours from any location in the world. In fact, BSE has replaced the open cry system with automated trading. Open cry system is a common method of communication between the investors at a stock exchange where they shout and use hand gestures to communicate and transfer information about buy and sell orders. It usually takes place on the 'pit' area of the trading floor and involves a lot of face to face interaction. However, with the use of electronic trading systems trading is easier, faster and cheaper; and is less prone to manipulation by market makers and brokers/dealers.

The Bolt system has enabled the exchange to meet the following objective:

- Reduce and eliminate operational inefficiencies inherent in manual systems
- Increases trading capacity of the stock exchange
- Improve market transparency, eliminate unmatched trades and delayed reporting
- Promote fairness and speedy matching
- Provide for on-line and off-line monitoring, control and surveillance of the market
- Smooth market operations using technology while retaining the flexibility of conventional trading practices
- Set up various limits, rules and controls centrally
- Provide brokers with their trade data on electronic media to interface with the

Broker's Back Office system

- Provide a sophisticated, easy to use, graphical user interface (GUI) to all the users of the system
- Provide public information on scrip prices, indices for all users of the system and allow the stock exchange to do information vending
- Provide analytical data for use of the Stock Exchange

2. National Stock Exchange (NSE)

Formation of National Stock Exchange of India Limited (NSE) in 1992 is one important development in the Indian capital market. The need was felt by the industry and investing community since 1991. The NSE is slowly becoming the leading stock exchange in terms of technology, systems and practices in due course of time. NSE is

the largest and most modern stock exchange in India. In addition, it is the third largest exchange in the world next to two exchanges operating in the USA.

The NSE boasts of screen based trading system. In the NSE, the available system provides complete market transparency of trading operations to both trading members and the participates and finds a suitable match. The NSE does not have trading floors as in conventional stock exchanges. The trading is entirely screen based with automated order machine. The screen provides entire market information at the press of a button. At the same time, the system provides for concealment of the identity of market operations. The screen gives all information which is dynamically updated. As the market participants sit in their own offices,

they have all the advantages of back office support, and facility to get in touch with their constituents. The trading segments of NSE are:

- Wholesale debt market segment,
- Capital market segment, and
- Futures & options trading.

NEAT

NSE uses satellite communication expertise to strengthen contribution from around 400 Indian cities. It is one of the biggest VSAT incorporated stock exchange across the world.

NSE is the first exchange in the world to use satellite communication technology for trading. Its trading system, called National Exchange for Automated Trading (NEAT), is a state of-the-art client server based application. At the server end all trading information is stored in an in memory database to achieve minimum response time and maximum system availability for users. It has uptime record of 99.7%. For all trades entered into NEAT system, there is uniform response time of less than one second.

3. Over the Counter Exchange of India (OTCEI)

The OTCEI was incorporated in October, 1990 as a Company under the Companies Act 1956. It became fully operational in 1992 with opening of a counter at Mumbai. It is recognised by the Government of India as a recognized stock exchange under the Securities Control and Regulation Act 1956. It was promoted jointly by the financial institutions like UTI, ICICI, IDBI, LIC, GIC, SBI, IFCI, etc.

The Features of OTCEI are:-

- OTCEI is a floorless exchange where all the activities are fully computerised.

- Its promoters have been designated as sponsor members and they alone are entitled to sponsor a company for listing there.
- Trading on the OTCEI takes place through a network of computers or OTC dealers located at different places within the same city and even across the cities. These computers allow dealers to quote, query & transact through a central OTC computer using the telecommunication links.
- A Company which is listed on any other recognised stock exchange in India is not permitted simultaneously for listing on OTCEI.
- OTCEI deals in equity shares, preference shares, bonds debentures and warrants.
- OTC Exchange of India designed trading in debt instruments commonly known as PSU bonds and also in the equity shares of unlisted companies.

Lesson-17

IMF and International Liquidity

International Monetary Fund

The International Monetary Fund, commonly referred to as the IMF, was created in 1944 and currently has about 188 member countries.

The IMF was created with the intention of:

1. Promoting global monetary and exchange stability.
2. Facilitating the expansion and balanced growth of international trade.
3. Assisting in the establishment of a multilateral system of payments for current transactions.

One goal of the IMF is to promote international cooperation on international monetary policy. Monetary policy is a country's decision regarding interest rates and money supply. The IMF also tries to encourage the expansion of international trade and promote currency exchange stability. Currency exchange rate stability means that the value of one currency in relation to another is fairly stable. Finally, the IMF helps countries meet their balance of payment obligations. Balance of payments is the difference in value between imports and exports in a country. A negative balance means there is more money going out of the country than coming in. The IMF can provide short-term financing if a country needs help with a negative balance of payment.

The IMF primarily uses three different tools to accomplish its mission. First, the IMF monitors the economic developments at the global level all the way down to individual nations. It tries to figure out how the monetary and fiscal policies of individual countries affect other countries and their economies. It also analyzes economic trends at all levels - from a global perspective down to a national perspective. Second, the IMF also provides training and technical assistance in four areas. The IMF offers technical assistance and training regarding monetary and fiscal policies. It also provides training and assistance in fiscal policy and management, including such things as tax and customs policies, budget formulation, designing of social safety nets, and management of debt. Assistance and training is also provided for compiling, managing, and improving statistical data. Finally, the IMF will help with economic and financial legislation.

Lending is the third tool that the IMF uses. The IMF provides short-term financing to help countries that need to correct their balance of payments. Remember, a negative balance of payments means that there is more money leaving the country than coming into it. A negative

balance of payments means that a country may not be able to pay its bills because it doesn't have enough currency. The IMF's short-term lending can help manage this problem and provide funds so that a country can honor its financial obligations. The aim of the lending is not to finance projects, like the World Bank's lending, but to stabilize economies and restore economic growth to economies in crisis.

Origins

The first half of the 20th century was marked by two world wars that caused enormous physical and economic destruction in Europe and a Great Depression that wrought economic devastation in both Europe and the United States. These events kindled a desire to create a new international monetary system that would stabilize currency exchange rates without backing currencies entirely with gold; to reduce the frequency and severity of balance-of-payments deficits (which occur when more foreign currency leaves a country than enters it); and to eliminate destructive mercantilist trade policies, such as competitive devaluations and foreign exchange restrictions—all while substantially preserving each country's ability to pursue independent economic policies. Multilateral discussions led to the UN Monetary and Financial Conference in Bretton Woods, New Hampshire, U.S., in July 1944. Delegates representing 44 countries drafted the Articles of Agreement for a proposed International Monetary Fund that would supervise the new international monetary system. The framers of the new Bretton Woods monetary regime hoped to promote world trade, investment, and economic growth by maintaining convertible currencies at stable exchange rates. Countries with temporary, moderate balance-of-payments deficits were expected to finance their deficits by borrowing foreign currencies from the IMF rather than by imposing exchange controls, devaluations, or deflationary economic policies that could spread their economic problems to other countries. After ratification by 29 countries, the Articles of Agreement entered into force on December 27, 1945. The fund's board of governors convened the following year in Savannah, Georgia, U.S., to adopt bylaws and to elect the IMF's first executive directors. The governors decided to locate the organization's permanent headquarters in Washington, D.C., where its 12 original executive directors first met in May 1946. The IMF's financial operations began the following year.

Organization

The IMF is headed by a board of governors, each of whom represents one of the organization's approximately 180 member states. The governors, who are usually their countries' finance ministers or central bank directors, attend annual meetings on IMF issues.

The fund's day-to-day operations are administered by an executive board, which consists of 24 executive directors who meet at least three times a week. Eight directors represent individual countries (China, France, Germany, Japan, Russia, Saudi Arabia, the United Kingdom, and the United States), and the other 16 represent the fund's remaining members, grouped by world regions. Because it makes most decisions by consensus, the executive board rarely conducts formal voting. The board is chaired by a managing director, who is appointed by the board for a renewable five-year term and supervises the fund's staff of nearly 3,000 employees from more than 120 countries. The managing director is usually a European and—by tradition—not an American. The first female managing director, Christine Lagarde of France, was appointed in June 2011.

Each member contributes a sum of money called a quota subscription. Quotas are reviewed every five years and are based on each country's wealth and economic performance—the richer the country, the larger its quota. The quotas form a pool of loanable funds and determine how much money each member can borrow and how much voting power it will have. For example, the United States' approximately $50 billion contribution to date is the most of any IMF member, accounting for approximately 18 percent of total quotas. Accordingly, the United States receives about 18 percent of the total votes on both the board of governors and the executive board. The Group of Seven industrialized nations (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States) controls nearly 50 percent of the fund's total votes.

Structure and Size of IMF

- 188 countries member.
- Headquarters: Washington, D.C.
- It has 2,300 staff members.

Qualifications

Any country may apply to be a part of the IMF. Post-IMF formation, in the early postwar period, rules for IMF membership were left relatively loose. Members needed to make periodic membership payments towards their quota, to refrain from currency restrictions unless granted IMF permission, to abide by the Code of Conduct in the IMF Articles of Agreement, and to provide national economic information. However, stricter rules were imposed on governments that applied to the IMF for funding.

The countries that joined the IMF between 1945 and 1971 agreed to keep their exchange rates secured at rates that could be adjusted only to correct a "fundamental disequilibrium" in the balance of payments, and only with the IMF's agreement.

Some members have a very difficult relationship with the IMF and even when they are still members they do not allow themselves to be monitored. Argentina, for example, refuses to participate in an Article IV Consultation with the IMF.

Benefits

Member countries of the IMF have access to information on the economic policies of all member countries, the opportunity to influence other members' economic policies, technical assistance in banking, fiscal affairs, and exchange matters, financial support in times of payment difficulties, and increased opportunities for trade and investment.

Leadership

Board of Governors

The Board of Governors consists of one governor and one alternate governor for each member country. Each member country appoints its two governors. The Board normally meets once a year and is responsible for electing or appointing executive directors to the Executive Board. While the Board of Governors is officially responsible for approving quota increases, Special Drawing Right allocations, the admittance of new members, compulsory withdrawal of members, and amendments to the Articles of Agreement and By-Laws, in practice it has delegated most of its powers to the IMF's Executive Board.

The Board of Governors is advised by the International Monetary and Financial Committee and the Development Committee. The International Monetary and Financial Committee has 24 members and monitors developments in global liquidity and the transfer of resources to developing countries. The Development Committee has 25 members and advises on critical development issues and on financial resources required to promote economic development in developing countries. They also advise on trade and environmental issues.

Executive Board

24 Executive Directors make up Executive Board. The Executive Directors represent all 189 member countries in a geographically based roster. Countries with large economies have their own Executive Director, but most countries are grouped in constituencies representing four or more countries.

Following the 2008 Amendment on Voice and Participation which came into effect in March 2011, eight countries each appoint an Executive Director: the United States, Japan, China,

Germany, France, the United Kingdom, the , and Saudi Arabia. The remaining 16 Directors represent constituencies consisting of 4 to 22 countries. The Executive Director representing the largest constituency of 22 countries accounts for 1.55% of the vote.[citation needed] This Board usually meets several times each week. The Board membership and constituency is scheduled for periodic review every eight years.

Managing Director

The IMF is led by a managing director, who is head of the staff and serves as Chairman of the

No	**Dates**	**Name**	**Nationality**	**Background**
1	6 May 1946 – 5 May 1951	Camille Gutt	Belgium	Politician, Minister of Finance
2	3 August 1951 – 3 October 1956	Ivar Rooth	Sweden	Law, Central Banker
3	21 November 1956 – 5 May 1963	Per Jacobsson	Sweden	Law, Economics, League of Nations, BIS
4	1 September 1963 – 31 August 1973	Pierre-Paul Schweitzer	France	Law, Central Banker, Civil Servant
5	1 September 1973 – 18 June 1978	Johan Witteveen	Netherlands	Economics, academic, author, politician, Minister of Finance, Deputy Prime Minister, CPB
6	18 June 1978 – 15 January 1987	Jacques de Larosière	France	Civil Servant
7	16 January 1987 – 14 February 2000	Michel Camdessus	France	Economics, Central Banker
8	1 May 2000 – 4 March 2004	Horst Köhler	Germany	Economics, EBRD
9	7 June 2004 – 31 October 2007	Rodrigo Rato	Spain	Law, MBA, politician, Minister of the Economy
10	1 November 2007 – 18 May 2011	Dominique Strauss-Kahn	France	Economics, Law, politician, Minister of the Economy and Finance
11	5 July 2011 – present	Christine Lagarde	France	Law, politician, Minister of Finance

Executive Board. The managing director is assisted by a First Deputy managing director and three other Deputy Managing Directors. Historically the IMF's managing director has been European and the president of the World Bank has been from the United States. However, this standard is increasingly being questioned and competition for these two posts may soon open up to include other qualified candidates from any part of the world.

In 2011 the world's largest developing countries, the BRIC nations, issued a statement declaring that the tradition of appointing a European as managing director undermined the legitimacy of the IMF and called for the appointment to be merit-based

Voting power

Voting power in the IMF is based on a quota system. Each member has a number of basic votes (each member's number of basic votes equals 5.502% of the total votes), plus one additional vote for each Special Drawing Right (SDR) of 100,000 of a member country's quota. The Special Drawing Right is the unit of account of the IMF and represents a claim to currency. It is based on a basket of key international currencies. The basic votes generate a slight bias in favour of small countries, but the additional votes determined by SDR outweigh this bias. Changes in the voting shares require approval by a supermajority of 85% of voting power.

The International Monetary Fund functions:

- The IMF is basically a lending institution which gives advances to members in need.
- It is the mentor of its members' monetary and exchange rate policies.
- To maintain the stability in Exchange rate system around the World.
- countries, working to foster global monetary cooperation, secure financial
- stability, facilitate international trade, promote high employment
- sustainable economic growth, and reduce poverty".
- IMF is to provide financial assistance to countries that experience serious financial difficulties
- Member states with balance of payments problems may request loans and/or organizational management of their national economies. In return, the countries are usually required to launch certain reforms, an example of which is the "Washington Consensus".

In text Questions

1. Explain the term "IMF"
2. Discuss the structure and functions of IMF

Lesson-18

Functions of World Bank

Structure

18.1 Introduction

International Bank for Reconstruction and development (IBRD) and its associate institutions as a group are known as the World Bank. The Second World War damaged economies of the most of the countries particularly of those who were directly involved in the war. The global war had completely dislocated the multilateral trade and had used massive destruction of life and property. In 1945, it was realised to concentrate on reconstructing these war affected economies. Besides, it was also given a thought to develop underdeveloped economies in a planned way. IBRD was established in December 1945 with the IMF on the basis of the recommendation of the Bretton Wood Conference. That is the reason why IMF and IBRD are called 'Bretton Wood Twins'. IBRD started functioning in June 1946. World Bank and IMF are complementary institutions.

The International Bank for Reconstruction and Development (IBRD) aims to reduce poverty in middle-income and creditworthy poorer countries by promoting sustainable development through loans, guarantees, risk management products, and analytical and advisory services. Established in 1945 as the original institution of the World Bank group, IBRD is structured like a cooperative that is owned and operated for the benefit of its 186 member countries.

IBRD raises most of its funds on the world's financial markets and has become one of the most established borrowers since issuing its first bond in 1947. The income that IBRD has generated over the years has allowed it to fund development activities and to ensure its financial strength, which enables it to borrow at low cost and offer clients good borrowing terms.

At its annual meeting in September 2006, the World Bank-with the encouragement of its shareholder governments-committed to make further improvements to the services it provides its members. To meet the increasingly sophisticated demands of middle-income countries, IBRD is overhauling financial and risk management products, broadening the provision of free-standing knowledge services and making it easier for clients to deal with the Bank.

India is a member of four constituents of the World Bank Group i.e. IBRD, IDA,IFC, MIGA (i.e. Multilateral Investment Guarantee Agency) but not of its fifth institute ICSID (i.e. International Centre for the Settlement of Investment Disputes).

18.2 Objectives of World Bank

According to the Clause I of the Agreement made at the time of establishment of World Bank, it was assigned the following objectives:

1. To provide long-run capital to member countries for economic reconstruction and development. World Bank provides capital mainly for following purposes.
   (i). To rehabilitate war ruined economies (this objective is fully achieved)
   (ii). To finance productive efforts according to peace time requirements.
   (iii). To develop resources and production facilities in underdeveloped countries.
2. To induce long-run capital investment for assuring BOP equilibrium and balanced development of international trade. (this objective was adopted to increase the productivity of member countries and to improve economic conditions and standard of living among them).
3. To promote capital investment in member countries by following ways:
   (i). To provide guarantee on private loans or capital investment.
   (ii). If private capital is not available even after providing guarantee, then IBRD provides loans for productive activities on considerate conditions.
4. To provide guarantee for loans granted to small and large units and other projects of member countries.
5. To ensure the implementation of development projects so as to bring about a smooth transference from a war-time to peace economy.

IMF vs. World Bank

IMF and the World Bank are Bretton Woods twins. Both the institutions were established to promote international economic co-operation but a basic difference is found in the nature of economic assistance given by these two institutions. World Bank provides long-term loans

for promoting balanced economic development, while IMF provides short term loans to member countries for eliminating BOP disequilibrium. Both these institutions are complementary to each other. The eminent World economist George Schultz had suggested in American Economic Association Conference in January 1995, for the merger of IMF and the World Bank.

Membership of the World Bank

Generally every member country of the IMF automatically becomes the member of the World Bank. Similarly, any which quits IMF is automatically expelled from the World Bank's membership. But under a certain provision a country leaving the membership of IMF can continue its membership with World Bank if 755 members of their bank give their vote in its favour.

Any member country can be debarred from the membership of World Bank on following grounds:

1. Any member country can quit the Bank simply by written notice to the Bank, but such country has to repay the granted loans on terms and conditions decided at the time of sanctioning the loan.
2. Any country working against the guidelines of Bank can be debarred from membership by the Board of Governors.

   Like IMF, World Bank have also two types of members: Founder members and General members. The World Bank has 30 founder members that attained membership by December 31, 1945. India is also among these founder members. The countries joining the World Bank after December 31, 1945, come under the category of general members. At the end of February, 2008, the total membership of the World Bank is 185. The voting right of member countries is determined on the basis of member country's share in the total capital of the bank. Each member has 250 votes plus one additional vote for each 1,00,000 shares of the capital stock held.

Capital Resources of World Bank

The initial authorised capital of World Bank was $ 10,000 million, which was divided in 1 lakh shares of $ 1 lakh each. The authorised capital of the bank has been increased from time to time with the approval of member countries. On June 30, 1996, the authorised capital of the bank was $188 billion out of which $ 180.6 billion (96% of total authorised capital)

was issued to member countries in the form of shares. Member countries repay the share amount to the World Bank in the following ways:

1. 2% of allotted share are repaid in gold, US dollar or SDR.
2. Every member country is free to repay 18% of its capital share in its own currency.
3. The remaining 80% share is deposited by the member country only on demand by the World Bank.

Bank is managed by an elected Chairman. Lewis Preston from USA was the Chairman of the World Bank who took over charge on June 1, 1995. He holds the additional charge as the Chairman of IDA and IFC. The headquarter of world Bank is at Washington D.C.

IDA (established on September 24, 1960) and IFC (established in july 1956) are the two main associate institutions of IBRD. These institutions work under the supervision of World Bank. MIGA is also an associate institution in the World Bank group.

Bank's Lending Operations

IBRD gives loan to members in any one or more of the following ways:

1. By granting or participating in direct loans but of its own funds.
2. By granting loans out of the funds raised in the market of a member or otherwise borrowed by the bank and
3. By guaranteeing in whole or part loans made by private investors through the investment channels.

   Before a loan is made or guaranteed the bank ensures that the-

   1) Project for which the loan is asked has been carefully examined by a competent committee as regards the merits of the proposal.
   2) Borrower has reasonable prospects for repayment of loans.
   3) The loan is meant for productive purposes and
   4) The loan is meant for reconstruction and development.

Functions of the World Bank

Presently, the World Bank is playing the main role of providing loans for development works to member countries, especially to underdeveloped countries. The World Bank provides long-term loans for various development projects of 5 to 20 years duration. The loaning system of the Bank can be explained with the help of the following points:

1. Bank can grant loans to a member country up to 20% of its share in the paid up capital.
2. Bank also provides loan to private investors belonging to member countries on its own guarantee, but for this loan private investors have to seek prior permission from those countries where this amount will be collected. For such loans the consent of that country is also required whose currency is given in loans. For granting such guarantee, the bank charges 1% to 2% as service charge.
3. The quantum of loans, interest rate and terms and conditions area determined by the Bank itself.
4. Generally, bank grants loan for a particular project duly submitted to the Bank by the member country.
5. The debtor nation has to repay either in reserve currencies or in the currency in which the loan was sanctioned.

   Besides, granting loans for reconstruction and development, World Bank also provides various technical services to the member countries. For this purpose, the bank has established. 'The Economic Development Institute' and a Staff College in Washington.

World Bank's Support to India

India has been borrowing from the World Bank through International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA) for various development projects in the areas of poverty alleviation, infrastructure,, rural development, etc. IDA funds are one of the most concessional external loans for Government of India (GOI) and are used largely in social sector projects that contribute to the achievement of Millennium Development Goals (MDGs). IBRD funds are relatively costlier but cheaper than commercial external borrowings. The Government of India utilises the IBRD loans primarily for infrastructure projects. However, sometimes a blend of IDA credits and IBRD loans is also used. India has borrowed around US $ 65.8 billion from the World Bank so far.

Appraisal of the World Bank Activities

Bank has sanctioned 75% of its total loans to developing countries of Africa, Asia and Latin America while only 255 was given to developed nations of Europe. IFC, IDA and MIGA were established as the associate institutions of the World Bank who also assisted the

World Bank in extending financial assistance to member countries. Besides, the bank has also tried its best to coordinate the functioning of nations granting loans to under developed countries. In 1958, the Bank played an important role in establishing 'India Aid Club' for providing specific economic assistances to India. It has now been renamed as 'India development forum'. Such type of clubs or forums have also been established for other developing countries. The Banks has also established its mission in various developing countries for providing technical assistance for development project in these countries. The Bank also take s the guidance of experts of various international institutions like FAO, WHO,UNIDO,UNESCO for providing assistance for various projects related to agriculture, education and water supply.

Appraisal of the World Bank Activities

18.5 Summary

In this lesson you have learnt that the World Bank established for the purpose of to removal imbalance between developed and developing nations across the world. It exhibits the aims and objectives of World Bank establishment. The text analysed the important Functions of World Bank. Moreover, it also examined the financial and Non-financial assistances, moral support accord the World Bank's to India. Finally, the text evaluates the performance of World Bank activities across the world.

18.6 In text Questions

1). Short note on "World bank"

2). Examine the objectives of World Bank

3). Examine the functions of World Bank

Lesson-19

Eurocurrency Markets

Structure

19.1 Introduction

The growth of Euro-Dollar Market is one of the significant developments in the international monetary scenario after Second World War.It has caused a profound influence upon the money and capital markets of the world such that the Euro-Dollar Market has become a permanent integral part of the international monetary system

Objectives

After reading this lesson you would be able to:

- Define the term “Euro-Dollar” and “Euro Currency Markets”
- Describe salient features and scope of Euro-Dollar
- Identify Factors Contributing to Growth of the Euro-Dollar Market
- Examine the Operation and Effects of Euro-Currency Market
- Describe the various Segments of Euro-Currency Market

19.2 Euro Dollar-Meaning and Scope:

In a narrow sense, Euro -Dollars are financial assets and liabilities denominated in US Dollars but traded in Europe. The US Dollar still dominates the European money market especially London money market. But the scope of the Euro-Dollar Market is

increased by leaps and bonds i.e. the Euro dollar transactions are also held in money markets beyond Europe and in currencies other than US dollar. Thus in a wider sense Euro-Dollar Market refers to transactions in a currency deposited outside the country of its issue. Any currency internationally demanded and supplied and in which the foreign bank is willing to accept liabilities and assets is eligible to become a Euro currency. As such dollar deposits with British Commercial Banks is called as Euro Dollar. Similarly pound sterling deposits with French commercial bank is called as Euro-sterling. Mark deposits in Italian banks get called as Euro-mark and so on. The market in which this sort of borrowing and lending of currencies take place is called as Euro currency market. Initially only dollar was used in this market. Subsequently, other leading currencies such as British pound sterling, the German mark, The Japanese Yen and the French and the Swiss Franc began to be used in this way. So the term ," Euro-Currency Market" is in popular use. The practice of keeping bank deposits denominated in a currency other than that of a nation in which the deposit is held has also spread to non-European countries. International European monetary centre such as Tokyo, Hongkong, Singapore and Kuwait. Even though outside Europe and even if denominated in yen, then deposits are after referred to as Euro-Currency because the market has been concentrated in Europe.

The Euro-Dollar Market consist of the Asian -dollar market, The Rio dollar Market, the Euro-Yen market, Euro-sterling, Euros-Swiss France, Euro-French Francs, Euro-Deutsche marks etc.

In short in these markets commercial banks accepts interest bearing deposits denominated in a currency other than the currency of the country in which they operate and they re-lend these funds either in the same currency or in the currency of the third country. In its annual report 1966, the Bank for International Settlement (BIS) described the Euro-Dollar phenomenon as "the acquisition of dollars by banks located outside the United State mostly thrones the taking of deposits, but also to some extent by swapping other currencies into dollars and the re-lending of these dollars after re-depositing with the other banks to non bank borrowers anywhere in the world."

The currencies involved in the Euro-Dollar market are not in any way different from the currencies deposited with the banks in the respective home country. But the Euro dollar is outside the orbit of monetary policy while the currency deposited with the banks in the respective home country is covered by the national monetary policy.

19.3 Salient Features of the Euro-Dollar Market:

Following are the characteristics features of the Euro-Dollar market.

1. International Market: The Euro-Dollar market is an International market. The Euro currency market emerged as the most important channel of mobilizing funds on an International scale.

2. Under no national control: By its very nature, the Euro-Dollar market is outside the direct control of any national monetary policy. The dollar deposits in London are outside the control of United States because they are in London . They are also outside the control of the British because they are in dollar. The growth of the Euro-Dollar market is due to the fact that it is outside the control of any national authority.

3. Short tern money market: It is a short term money market. The deposits in this market rage from one day up to one year. Euro dollar deposits are predominantly a short term investment.

The Euro dollar market is a credit market. It is a market in dollar bank loans. The Euro dollar loans are employed for long term loans.

4. It is a whole sales market: The Euro-dollar market is a wholesale market in the sense that the Euro dollar is a currency which is dealt only in large units. The size of an individual transactions is usually above $ 1 million.

5. A highly competitive and sensitive market: It is a highly competitive and sensitive market. It's growth and expansion tells us that it is highly competitive market. It is reflected in the responsiveness of the supply of and demand for funds to changes in the interest rates and vice-versa.

19.4 Euro-Dollar Origin and Growth

The origin of the Euro-dollar market can be traced back to 1920's when the United States dollars were converted into local currencies for lending purposes. However, the growth of the Euro-dollar market began to gain momentum only in late 1950's. Since 1967 the growth of the Euro-dollar market has been very rapid. The flow of petro-dollar s has given it an added momentum in 1970's.

As per BIS estimates its size grew from $ 2 billion in 1960 to 256.8 billion in 1969. $ 75.3 billion in 1970, $ 97.8 billion in 1971 and 131.9 billion in 1972. By 1984 the size of the market reached $ 2,325 billion.

19.5 Factors Contributing to Growth of the Euro-Dollar Market:

1. Balance of Payment Deficit of USA : The large and persistent deficit in the balance of payments of USA increased the flow of US dollars in these countries having surplus balance of payments in relation to USA. The USA has a deficit in the balance of payments since 1950 extent in 1957 and since 1956 the balance of payments deficits have assumed alarming proportion. Hence, it was one of the most important factors responsible for the rapid growth of the Euro-dollar market.

2. Banking Regulation in USA: The Federal Reserve system of USA issued regulation "Q" in USA which fixed the minimum rate of interest payable by the member banks in USA. It also prohibited the payment of interest on deposit for less than 30 days. These things significantly contributed to the growth of Euro-dollar market. The Euro-dollar rates of interest were comparatively higher than the US interest rates which attracted the Collar deposits from USA to European countries. The selective controls in the United [States such as interest rate equalization and the voluntary restrictions on lending and investing abroad by United States corporations and banks also led to widening of the f Euro-Dollar market.

3. Innovative Banking : The advent of innovative banking, sphere headed by the American banks in Europe and the willingness of the banks in Europe in the Euro-Dollar ketto operate on a narrow spread, also encouraged the growth of Euro-Dollar market.

4. Supply and Demand : The supply and demand for funds in the Euro-currency market comes from the participants in the Euro-currency business viz. the Governments, International organizations, central banks, commercial banks, corporation's especially multinational corporations, traders and individuals etc. Governments have emerged as significant borrowers in the Euro-currency market. The frequent hike in price and the consequent increase in the current account deficits of number of countries compel then to increase their borrowings. The central banks of various countries constitute the important supplying. The bank of the central banks funds are channelled through BIS. The enormous oil revenue of OPEC countries has become an important source of flow of funds to the Euro-Dollar market. Multinational corporations and trader, too place their surplus funds in the market to obtain short term gains. The commercial banks in need of additional funds for lending purposes may borrow from the Euro market and relent it. At the end of the financial year, they sometimes resort to borrowing for "window dressing" purposes.

5. Supply of Petrodollars : The flow of Petro-dollars facilitated by the tremendous increase in OPEC oil revenue following the frequent hikes in oil prices since 1973 has been a significant factor in the growth of Euro-Dollar market. The Euro-Dollar market grew especially rapidly after 1973 with the huge dollar deposits from OPEC arising from the manifold increase in the price of petroleum.

6. The Suez Crises: The Suez crisis occurred in 1957. During the crisis the restrictions were place upon the sterling credit facilities for financing trade provided a stimulus for the growth of Euro-Dollar market. The British banks which could not meet the demand for credit from traders found out a good alternative to meet the demand for credit in terms of Euro-Dollar.

7. Relaxation of Exchange controls and Resumptions of currency convertibility: The relaxation of exchange control, the stability in the exchange market, and the resumption of currency convertibility in Western Europe in 1958 provided a fresh impetus to the growth of Euro-Dollar market. Due to resumption of currency convertibility and the comparative higher rate of interest attracted the flow of US dollars from USA to Europe. The US dollars could be converted into domestic currency to finance domestic economic activity.

8. Political Factor: The cold war between the United States and the communist countries also contributed to the growth of Euro-Dollar market. In the event of hostilities the communist countries feared, that there would be blocking of their dollar deposits and hence the communist countries deposited their dollar holdings with the East European banks. This move led to the growth of the Euro-Dollar market.

19.6 Operation and Effects of Euro-Currency Market

Euro-currencies are money substitutes or near money rather than money itself as they are in the form of demand deposits. Euro banks do not create money, but they are essentially financial intermediaries. They bring together lenders and borrowers. They function more like domestic saving and loan associations rather than commercial banks in the United States. In the east, the United States and oil exporting countries have been the main lenders of Euro-Dollar funds while developing countries, the Soviet Union and eastern European countries have been the major borrowers. The Euro-currency market performed in recycling hundreds of billions of petro-dollars from oil exporting countries to oil importing countries during 1970's. This has paved the way for the huge International debt problems of developing countries, particularly those of Latin America.

19.7 Problems Created By Euro-Currency Market

Following are the problems created by the Euro-currency market.

1. It reduces the effectiveness of domestic stabilization efforts of national Governments. For example, large firms cannot borrow domestically because of credit restrictions instead they borrow from the Euro-currency market. Thus it is frustrating the Government effort to restrict credit to fight domestic inflationary pressure.

2. It creates another problem i.e. the frequent and large flows of short term Euro-Currency funds from one International monetary centre to another which produce great instability in foreign exchange rates and domestic interest rates.

3.Euro-currency markets are largely uncontrolled as a result of which the world wide recession may lead to insolvency of the banks i.e. the International bank panic which affected capitalist nations during the 19thcentury and the starting of the 20th century.

19.8 Segments of Euro-Currency Market

The Euro-currency market can broadly be divided into three segments which are as follows:

i). Euro credit markets where International group of banks get engaged in lending funds for medium and long term.

ii). Euro-bond market where banks raise funds on behalf of International borrowers by issuing bonds.

iii). Euro-currency (deposits) market where banks accept deposits mostly for short term.

19.9 Euro Credits:

Most of the lending in Euro currency market takes the form of Euro credit. Euro credits are medium and long term loans. Euro-credits belong to wholesales sector of the International Capital market and normally involve large amounts.

Euro-credits are provided mostly without any collateral security from the borrower. Here emphasis is laid on credit rating i.e. credits worthiness of the borrower rather than on only tangible security.

Euro-credits are normally provided in either of the two forms:-

a) Revolving credit, and

b) Term Credit,

A) Revolving Credit is similar to a cash credit facility. It is a stand by facility to meet temporary but recurring financial requirements of the borrower. Interest is charged on the actual amount utilized, a commitment fee may be changed on unutilized portion.

B) Term Credit is similar to medium term loans provided by banks. At the beginning both the lenders and borrowers agree on the schedule of changing the facility. The repayment schedule is fixed taking into account the expected revenue flow from the investment. Many loan agreements provide for pre-payment of the full amount without any penalty at 30 days or 60 days notice. This provision helps the borrowing companies to repay the loan and avail of better conditions that may prevail in the market at a later date.

The period of Euro-credit extends up to 15 years. But most of the credits are for 5 to 8 years. Interest is fixed at a certain percentage, generally the inter banks rate for Eurocurrency deposits. For dollar loans the reference rate is LIBOR i.e. London Inter Bank Offered Rate. Generally, interest for dollar loan .is fixed at a percentage over LIBOR i.e. 1 % over LIBOR. Technically the credit is rolled over or renewed every six months. The variations are allowed from the method of rolling over the interest every six months at a fix percentage over LIBOR. Many of the loans raised are in dollars. The borrower is given the option to roll over \the loan in different currencies according to his requirements. The multi currency option j helps the borrower in avoiding exchange risk and also doesn't involve the lending bank in any risk. Since it is not possible for single bank to meet all the demand for loan the banks form the syndicate to provide funds to the borrower.

19.10. Euro-Bonds:

The Euro-bonds are International bonds. They are the main source of borrowing in the Euro-markets. Euro-bonds are those bonds which are sold for International borrowers in several Euro markets simultaneously by the International group of banks. They are issued on behalf of multinational corporations, International agencies "and Governments Initially the borrower were belonging to the developed countries. Later on developing countries entered into the Euro-market on a very large scale. Euro-bonds are unsecured securities When they are issued by Governments, corporations and local bodies they are guaranteed by the Government of the country concerned Selling of Euro bonds is done through syndicates. The lead manger bank is responsible for advising on the size of the issue, terms and timing and for co-coordinating the issue. Lead managers take the help of co-managing banks. Most of the Euro-bond is bearer securities. Most of the Euro-

bonds are denominated in US dollars issued in denominations of $ 10,000. The average maturity of Euro-bond is 5 to 6 years. The maximum maturity is 15 years.

There are **four types** of Euro-bonds which are as follows:

1 Straight or Fixed rate bonds,

2 Convertible bonds

3 Currency option bonds,

4 Floating rate notes.

Straight or Fixed rate bonds are fixed interest bearing securities, the interest normally payable at yearly intervals. Maturities range from 3 to 25 years.Convertible bonds are also fixed interest bearing securities. The investor has the options to convert them into equity share of the borrowing company. The conversion will be done at a stipulated price for the shares and during a stipulated period. The currency options bonds are similar to straight bonds. The difference between these two bonds is that it is issued in one currency with the option to take payment of interest and principal in second currency. Normally option bonds are issued in sterling and provide option for payment in dollar or Deutsche mark. The floating rate notes (FRNS)were issued in 1970 and now they occupy a prime position in the Euro-bond market. The FRNS are similar to straight bonds in respect of maturity and denomination. The difference is that it is payable in varying in accordance with the market conditions unlike the fixed rate payable on a straight bond.

19.11 Euro-Currency Deposits:

Euro-currency is the funds to collect in large quantities by the banks on behalf of International borrowers. The Euro currency deposits represent the funds accepted by the banks themselves. The Euro-currency market consists of all deposits of currencies placed with banks outside their home currency. The deposits are accepted in Euro-currency.

The Euro-currency time deposits are the most important investment in the Euro-Dollar market. The deposits may be placed at call or for fixed period on time deposits. Call deposits may be made for overnight, two days or seven day notice for US dollars. Canadian dollar, Sterling and Japanese Yen and a minimum notice of two days for other currencies. Time deposits are accepted for a period of 1, 3,6 and 12 months for all currencies. There is a close link in the functioning of the Euro-currency deposit market and foreign exchange market. Deposits in US dollar and Pound Sterling can be placed for periods up to five years. In general, the minimum size of deposit in Euro-currency market is $ 50,000

or its equivalent. The interest rates in Euro-currency market are determined by the factors which affect the demand and supply conditions of the currency concerned viz.

i) Volume of world trade transacted in the currency,

ii) Domestic interest rates,

iii) Domestic monetary policy and reserve requirements,

iv) Domestic Government regulations,

v) Relative strength of the currency in the foreign exchange market, In practice domestic interest rates act as a floor to Euro-currency rates because the funds flow into Euro-currency market seeking higher interest. Although the Euro-currency market operates in number of centers around the world, interest rates for a particular currency are consistent. Any temporary variations at different market are quickly eliminated by the International arbitrage. The following are some of the additional observation of the Euro-dollar market:

1) A Euro-Bank is not subject to foreign exchange risk. Its dollar assets are equal to its dollar liabilities. This does not mean that Euro-Bank can not speculate.

2) The Euro-dollar market is a highly organized capital market that facilitates the financing of international trade and investment. The competition in the Euro currency markets is quite keen, with banks carrying on arbitrage operation between the dollar and other markets. Interest parity is usually maintained.

3) The Euro-dollar market has not been subject to any overall official regulation even though spotty requirements have marred from time to time rather free character of the market. Thus Euro-dollar market can potentially create dollars in the same way commercial banks create credit. Because of Several leakages the money multiplication is rather low.

The Euro-dollar banks behave more like the savings and loan association rather than the commercial banks of the United States.

19.12 Summary

In this lesson you have learnt that:

- The meaning and definition of the concept on “Euro-Dollar” and “Euro-Currency Markets”.
- Understand on salient features of Euro-dollar
- Examined the important factors influencing the growth of Euro-Dollar Market

19.13. In text Questions

1. Define the term “Euro-Dollar” and “Euro Currency Markets”

2. Describe salient features and scope of Euro-Dollar
3. Explain the Factors Contributing to Growth of the Euro-Dollar Market
4. Examine the Operation and Effects of Euro-Currency Market
5. Describe the various Segments of Euro-Currency Market

Lesson-20

Role of Asian Development Banks

Structure

Objectives

20.1 Asian Development Bank-Introduction

The Asian Development Bank aims for poverty free Asia and Pacific. Approximately 1.7 billion people in the region are poor and unable to access essential goods, services, assets and opportunities to which every human is entitled. Since its foundation in 1966, ADB has been driven by an inspiration and dedication to improving people's lives in Asia and the Pacific. ADB is committed to helping developing member countries evolve into modern economies that are well integrated with each other and the world through investment in infrastructure, health care services, financial and public administration systems, or helping nations prepare for the impact of climate change or better manage their natural resources. The main devices for assistance are loans, grants, policy dialogue, technical assistance and equity investments.

20.2 Key achievements of ADB

Asian Development Bank (ADB) aims for an Asia and Pacific free from poverty. While it has achieved a significant reduction in extreme poverty, the region remains home to about two-thirds of the world's extremely poor.

–With $21.57 billion in approved financing in 2012 and 3,045 employees from 61 of its 67 members, ADB in partnership with member governments, independent specialists and other financial institutions is focused on delivering projects that create economic and development impact.

–Environmental sustainability is a core strategy of ADB's work as it is the poor that are most severely affected. Environmental damage and resource depletion are already impeding the region's development and reducing the quality of life.

–ADB is active in creating the framework for the private sector to be involved in investing in new projects that underpin development and improve the lives of the 1.7 billion people in the region who live on less than $2 a day.

–Since 2000, the Asian Development Fund has transformed the region with the construction of thousands of schools, bridges, health clinics and roads, providing opportunities for people to lift themselves out of poverty.

–Over the past 6 years, ADB, through the Asian Development Fund has: expanded the access of more than 19 million students to quality education by building or upgrading more than 60,000 classrooms and training 720,000 teachers; helped more than 252 million people gain better access to wider economic opportunities and social services by building or upgrading more than 56,000 (km) of roads; provided more than 2.1 million households with access to clean water by installing or rehabilitating about 14,000 km of water supply pipes; connected more than 1.8 million households to electricity by building or upgrading more than 35,000 km of power transmission and distribution lines; and reduced greenhouse gas emissions by 2 million tons of carbon dioxide equivalent per year by promoting more efficient and cleaner energy operations.

20.3 Structure of Asian Development Bank

20.3.1 ADB - Membership

Membership in the bank is open to members and associate members of the United Nations Economic and Social Commission for Asia and the Pacific; and other regional countries and non-regional developed countries that are members of the United Nations or of any of its specialized agencies. ADB was established with 31 members in 1966. Today ADB has grown to encompass 67 members - of which 48 are from within Asia and the Pacific and 19 outside.

20.3.2 Board of Governors

Article 28 of the ADB Charter vests all the powers of the institution in the Board of Governors, which in turn delegates these powers to the Board of Directors, except for those powers reserved for the Board of Governors in the Charter. The Board of Governors meets formally once a year in ADB's Annual Meeting.

20.3.3 Board of Directors

The 12 members of the Board of Directors are elected by the Board of Governors. Eight of those 12 are elected by member countries from within the Asia Pacific region, and the four others are elected by member countries from outside the region. Each Director appoints an

Alternate. The President of ADB chairs the Board of Directors. The Board of Directors performs its duties full time at the ADB headquarters in Manila, Philippines, and holds formal and executive sessions regularly. The Directors supervise ADB's financial statements, approve its administrative budget, and review and approve all policy documents and all loan, equity, and technical assistance operations

20.3.4 Management

The President is Chairperson of the Board of Directors, and under the Board's direction, conducts the business of ADB. He is responsible for the organization, appointment, and dismissal of the officers and staff in accordance with regulations adopted by the Board of Directors. The President is elected by the Board of Governors for a term of five years, and may be re-elected. He is also the legal representative of ADB. The President heads a management team comprising six Vice-Presidents and the Managing Director General, who supervise the work of ADB's operational, administrative, and knowledge departments

20.4 Policies and Strategies for ADB

The Long-Term Strategic Framework of the Asian Development Bank 2008-2020 "Strategy 2020" identifies drivers of change that will be stressed in all its operations - developing the private sector, encouraging good governance, supporting gender equity, helping developing countries gain knowledge, and expanding partnerships with other development institutions, the private sector, and with community-based organizations. By 2012, 80% of ADB lending will be in five core operational areas, identified as comparative strengths of ADB:

–Infrastructure, including transport and communications, energy, water supply and sanitation and urban development

–Environment

–Regional cooperation and integration

–Finance sector development

–Education

ADB will continue to operate in health, agriculture, and disaster and emergency assistance, but on a more selective basis. ADB has developed a corporate results framework to assess its progress in implementing Strategy 2020. Annually, it will monitor implementation through the ADB Development Effectiveness Review.

20.5 History of ADB

ADB was conceived amid the postwar rehabilitation and reconstruction efforts of the early 1960s. The vision was of a financial institution that would be Asian in character and foster economic growth and cooperation in the region - then one of the poorest in the world. A resolution passed at the first Ministerial Conference on Asian Economic Cooperation held by the United Nations Economic Commission for Asia and the Far East in 1963 set that vision on the way to becoming reality. The Philippines capital of Manila was chosen to host the new institution - the Asian Development Bank - which opened on 19 December 1966, with 31 members that came together to serve a predominantly agricultural region. Takeshi Watanabe was ADB's first President. For the rest of the 1960s, ADB focused much of its assistance on food production and rural development. Its operations included ADB's first technical assistance, loans, including a first on concessional terms in 1969, and bond issue in Germany.

ADB's assistance expanded in the 1970s into education and health, and then to infrastructure and industry. The gradual emergence of Asian economies in the latter part of the decade spurred demand for better infrastructure to support economic growth. ADB focused on improving roads and providing electricity. When the world suffered its first oil price shock, ADB shifted more of its assistance to support energy projects, especially those promoting the development of domestic energy sources in member countries. Co financing operations began to provide additional resources for ADB projects and programs. ADB first bond issue in Asia - worth $16.7 million and issued in Japan - took place in 1970. A major landmark was the establishment in 1974 of the Asian Development Fund to provide concessional lending to ADB's poorest members. At the close of the decade, some Asian economies had improved considerably and graduated from ADB's regular assistance. At the close of the decade, some Asian economies had improved considerably and graduated from ADB's regular assistance. In the 1980s ADB made its first direct equity investment and began to use its track record to mobilize additional resources for development from the private sector. In the wake of the second oil crisis, ADB continued its support to infrastructure development, particularly energy projects. ADB also increased its support to social infrastructure, including gender, microfinance, environmental, education, urban planning, and health issues. In 1982, ADB opened its first field office - a Resident Mission in Bangladesh - to bring operations closer to their intended beneficiaries. Later in the decade, ADB approved a policy supporting collaboration with nongovernment organizations to address the basic needs of disadvantaged groups in its developing member countries. In the

1990s ADB begin promoting regional cooperation, forging close ties among neighboring countries in the Greater Mekong Sub region. In 1995, ADB became the first multilateral organization to have a Board-approved governance policy to ensure that development assistance fully benefits the poor. Policies on the inspection function, involuntary resettlement, and indigenous peoples - designed to protect the rights of people affected by a project - were also approved. ADB's membership, meanwhile, continued to expand with the addition of several Central Asian countries following the end of the Cold War. In mid-1997, a severe financial crisis hit the region, setting back Asia's spectacular economic gains. ADB responded with projects and programs to strengthen financial sectors and create social safety nets for the poor. ADB approved its largest single loan-a $4 billion emergency loan to the Republic of Korea-and established the Asian Currency Crisis Support Facility to accelerate assistance. In 1999, recognizing that development was still bypassing so many in the region, ADB adopted poverty reduction as its overarching goal. In 2003, a severe acute respiratory syndrome (SARS) epidemic hit the region, making it clear that fighting infectious diseases requires regional cooperation. ADB began providing support at national and regional levels to help countries more effectively respond to avian influenza and the growing threat of HIV/AIDS. ADB also had to respond to unprecedented natural disasters, committing more than $850 million for recovery in areas of India, Indonesia, Maldives, and Sri Lanka hit by the December 2004 Asian tsunami. In addition, a $1 billion line of assistance to help victims of the October 2005 earthquake in Pakistan was set up. In 2008, ADB's Board of Directors approved Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank 2008-2020, a policy document guiding its operations to 2020. In 2009, ADB's Board of Governors agreed to triple ADB's capital base from $55 billion to $165 billion, giving it much-needed resources to respond to the global economic crisis. The 200% increase is the largest in ADB's history and the first since the 1994 100% capital increase.

20.6 Functions of ADB

–ADB raises funds through bond issues on the world's capital markets. We also rely on our members' contributions, retained earnings from our lending operations, and the repayment of loans.

–It provides loans and grants from a number of Special Funds. The largest is the Asian Development Fund, which offers grants and loans at very low interest rates.

–ADB's highest policy-making body is the Board of Governors, which meets annually and comprises one representative from each member nation – 48 from the Asia-Pacific and 19 from outside the region. The Governors elect 12 members of the Board of Directors. The ADB President, assisted by six Vice Presidents and a Managing Director General, manages the business of ADB.

–ADB consults people from all sections of society to ensure that projects, programs, and strategies meet people's needs. The country partnership strategy - the main planning document at the country level -emphasizes consultation with the government, the private sector, civil society, and all project stakeholders.

20.7 India and ADB

India has been a founding member of the Asian Development Bank (ADB) since its establishment in 1966. Since the beginning of its lending operations in the country in 1986, ADB has partnered with India in its endeavor to reduce poverty through infrastructure-led growth. Over the years, ADB has aligned its India program with the government's increasing focus on inclusive and sustainable growth. While continuing its support for infrastructure development in the energy, transport, and urban sectors, ADB is also now engaged in improving water resources management, agribusiness infrastructure development, promoting financial inclusion, and skills development.

In line with the government's Finance Plus approach, ADB has been infusing innovations and regional best practices into project design and implementation. ADB has focused on strengthening its partnership with multilateral and bilateral development partners in India. In 2012, consultations and programming-related meetings were held with several key partners. Such consultations help ADB in being more responsive to development needs besides being useful in identifying strategies and approaches that add value to its overall program in India.

ADB's partnerships with civil society organizations aim to strengthen the effectiveness, quality, and sustainability of development efforts. Civil society organizations partnering in ADB operations provide a grassroots perspective on the design and implementation of projects, assist in community mobilization and resettlement, provide technical training, and conduct independent monitoring and evaluation.

Operational Challenges: Rapid economic growth in India over the past 2 decades has lifted millions out of poverty. However, income disparities and regional imbalances remain. To supplement the government's efforts in reducing interstate disparities and promoting

regionally balanced growth, ADB has expanded its operations in low income and special category states. These states face one or more of the following constraints–high poverty, low incomes, low levels of social development, weak capacity, and inadequate infrastructure. From 2009 to 2012, between 60% to 80% of ADB's project approvals involved such states. An important aspect of ADB's engagement in these states has been its support to strengthening the capacities of executing agencies in planning and implementation of infrastructure projects, and exposing them to new technologies and international and regional best practices. The Capacity Development Resource Center at ADB's India Resident Mission is playing a key role in institutionalizing support to executing agencies. It has strengthened its ties with national training institutes and is committed to becoming a focal point for capacity building and knowledge solutions in the infrastructure domain. In tandem, enhanced tripartite review meetings involving ADB, the Government of India, and executing agencies are helping to not only minimize delays in project implementation, but also improve readiness and innovativeness of projects in the pipeline.

Future Directions: ADB will continue to support the strategic goals of the government–faster, more inclusive, and sustainable growth– as emphasized in the 12th Five-Year Plan and reflected in ADB's country partnership strategy (CPS), 2013–2017 for India, currently being formulated. The strategic pillars of the new CPS will emphasize three agendas: support for inclusive growth, environmentally sustainable growth, and regional integration. Continued support to the development efforts of low-income and special category states will remain a key plank of operations over the new CPS period. Concurrently, operations will be designed around selected flagship operations that support the development of high-priority economic corridors, create markets for infrastructure finance, and promote regional cooperation and integration through the South Asia Sub-regional Economic Cooperation (SASEC) platform. The 3-year lending program over 2013–2015 will average around $2 billion annually in terms of sovereign operations. The funds will be allocated across four core infrastructure sectors– transport, energy, urban, and agriculture and natural resources– and two cross-cutting sectors–finance and skills development. ADB's private sector operations will continue to support ADB's strategic priorities in these areas.

India is ADB's fourth largest shareholder. Since launching its lending operations in India in 1986, ADB has approved 168 sovereign loans amounting to $27.2 billion. As of 31 December 2012, the portfolio included 78 ongoing sovereign loans amounting to $11.2

billion. ADB's sovereign lending assistance to India increased from an annual average of about $1.16 billion in 2000–2006 to $1.85 billion in 2007–2012. India has been ADB's largest borrower for the last 3 years (2010–2012).

ADB-Supported Projects and Programs ADB-supported projects and programs have had significant development impacts and worked toward improving the lives of the ultimate beneficiaries in following ways:

–The Madhya Pradesh State Roads II (2007–2011) project facilitated construction and rehabilitation of approximately 1,800 kilometers (km) of state roads, thereby improving access to business opportunities and social services, particularly benefiting small business owners and farmers. ADB-supported initiatives in the energy sector are helping India scale up access to electricity through projects like the Assam Power Sector Enhancement Investment Project (2009– 2014). The financing facility will strengthen the transmission and distribution system and is expected to benefit around 1 million households, businesses, hospitals, and schools through increased access to power.

–ADB-assisted Chhattisgarh Irrigation Development Project (2005–2013) is supporting a participatory irrigation management approach to rehabilitate and upgrade irrigation infrastructure to improve water resource management, helping increase productivity of irrigated agriculture and enhancing livelihoods in the state. More than 150,000 farmers will benefit.

–Meanwhile, the Kolkata Environmental Improvement Project (2000–2012) has improved overall living and environmental conditions for nearly 1.4 million inhabitants through the construction of 331 km of sewage and drainage networks. Recent projects and programs include an innovative partial credit guarantee facility that will support credit enhancements of infrastructure project bonds to enable cash-rich pension funds and insurers to invest in such bonds (India Infrastructure Finance Company Limited–Credit Enhancement of Project Bonds); and assistance to West Bengal for stabilizing its fiscal situation and encouraging reforms of administrative processes to promote efficient public spending and improvements in revenue collection (West Bengal Development Finance Program). Co-financing operations enable ADB's financing partners, governments or their agencies, multilateral financing institutions, and commercial organizations, to participate in the financing of ADB projects. The additional funds are provided in the form of official loans and grants, and commercial financing, such as B loans, risk transfer arrangements, parallel loans, and co-financing for transactions under ADB's Trade Finance Program. By the

end of 2012, cumulative direct value-added official co-financing for India amounted to $1.09 billion for 17 investment projects, and $87.8 million for 105 technical assistance projects. In 2012, India received $200 million loan co-financing from the Government of Germany for Himachal Pradesh Clean Energy Development Investment Program–Tranche 4, and $2.5 million grant co-financing from the Japan Fund for Poverty Reduction for Livelihood Improvement for River Erosion Victims in Assam.

As a catalyst for private investments, ADB provides direct financial assistance to non sovereign public sector and private sector projects in the form of direct loans, equity investments, guarantees, B loans, and trade finance. Since its inception, ADB has approved a total of $3,338.3 million in non sovereign financing for India, $2,060.3 million of which were for 38 private sector projects. Total outstanding balances and commitments of ADB's non sovereign transactions in the country as of 31 December 2012 totalled $1,722.1 million, representing 23.5% of ADB's total non sovereign portfolio.

Procurement: From 1 January 1966 to 31 December 2012, contractors and suppliers were involved in 185,090 contracts for ADB loan projects worth $116.58 billion. During the same period, contractors and suppliers from India were involved in 7,973 contracts for ADB loan projects worth $14.74 billion. From 1 January 1966 to 31 December 2012, consultants were involved in 11,990 contracts for ADB loan projects worth $5.11 billion. During the same period, consultants from India were involved in 383 contracts for ADB loan projects worth $345.99 million. From 1 January 1966 to 31 December 2012, consultants were involved in 26,546 contracts for ADB technical assistance projects worth $3.1 billion. During the same period, consultants from India were involved in 1,673 contracts for ADB technical assistance projects worth $144.20 million.

20.8 Summary

In this lesson you have learnt that:

- The Asian development established with the aim of several goals.
- The structure and administration of ADB
- Policies and Strategies for ADB
- To examine the important functions of ADB

20.9 In text questions

1) Explain the objectives of Asian Development Bank.
2) Discuss the Policies and Strategies for ADB
3) Examine the functions of ADB

4) Describe the role of ADB in India.

5) Give an account of the role play by ADB in developing countries.