University of Jammu

Syllabus

Semester-V (CBCs) **Title: Money and Banking**

(Course Code: UECTE: 501) **Credits: 6**

Preamble: This course on Money and Banking will provide the students a thorough understanding and knowledge of operations of money and banking systems and their interaction with the rest of the economy. It will focus on essential aspects of how monetary forces operate through a multitude of channels-market, non-market institutions and among others. The contents of this paper have laid emphasis on money and banking and its integration with monetary theory, banking institutions and government and how money and banking constitutes important components towards understanding of economics.

UNIT 1: Money and Its Functions

Evolution of money, Money: Meaning and functions; Classification of money: Money and Near Money; Qualities of good money material; Role of money in a developing and mixed economy: Gresham's Law

UNIT-2: Price Index Numbers and Theories of Money

Price Index Numbers: Meaning and types; Steps in Construction of Price Index Numbers; Conceptual and Practical difficulties in the Measurement of Index Numbers; Importance of Index Numbers: Fisher's Transactions Approach and Cambridge Cash Balance Approach; A comparison of Fisherian and Cambridge Versions

UNIT-3: Commercial Banks

Commercial Banks: Meaning and functions; Types of Banks; Role of Commerc Banks in a developing economy, Process of Credit creation; Structure of Indian Commercial Banking; Banking Sector Reforms in India since 1991

UNIT-4: Central Banking

Central Bank: Meaning and Functions; Objectives of Credit Control: Qualitative and quantitative Methods of Credit Control; Role of Central Bank in Developing Economy: Difference between Central Bank and Commercial Bank.

UNIT-5: Monetary and Fiscal Policies

Monetary and fiscal policy: Meaning, Features; Role of Monetary and Fiscal policy in developing countries; Monetary Policy Effects on Demand, Fiscal Policy Effects on Demand, Fiscal Policy and Investment, Interaction of Monetary and Fiscal Policies.

UNIT-1: Money and Its Functions

EVOLUTION OF MONEY

"Money is what money does". Money can be defined as any commodity that is generally accepted as a medium of exchange & a measure of value.

According to D.H. Robertson:"Anything which is widely accepted in payment for goods, or discharge of other kinds of obligations."

H.G. Johnson has classified the approaches to the definitions of money.

(a) The Conventional Approach: The conventional approach of definition of money emphasises the basic functions of money i.e., the medium of exchange & measure of value. Thus, according to this school, Money stock Cash + Demand Deposits. This definition of money includes only currency & Demand deposits.

(b) The Chicago Approach: Prof. Milton Friedman is the leader of this School.

Chicago approach has broadened the definition of money to three components:

(i) Currency

(ii) Chequeable Demand Deposits

(iii) Time Deposits.

The basic idea underlying their approach is that they do not regard money mere medium of Exchange, measure of value but also as a store of value.

(c) The Gurley-Shaw Approach: This approach attributed to John G Gurley & Edward S. Shaw. They go one step further & recognise the asset function of the "financial claims against the non-banking financial intermediaries." They emphasise close substitution relationship between currency, demand deposits. Commercial bank time-deposits, Saving bank deposits, Saving & loan association Shares & so on, all of which are viewed by public as alternative liquid stores of value.

(d) The Central Bank Approach: The central bank approach is accredited to the Redcliffe committee of the USA. This committee emphasizes the Similarity between currency & other realizable assets or means of purchasing. Therefore, money in a way the total credit flow to the borrowers.

Classification of Money

Broadly, Money can be classified as:

(i) Full Bodied Money

(ii) Representative Full Bodied Money

(iii) Credit Money

(i) Full Bodied Money: Any unit of money whose face value & intrinsic value are equal is known as full Bodied Money.

For example, During the British rule, one (1) rupee coin was made of silver & its money value was same as its value as a commodity.

(ii) Representative Full Bodied Money : It refers to money which is usually made of paper. The value of representative full bodied money is much higher than its value as a commodity. It is accepted as money as it can be conveniently used for carrying out transactions.

There are two types of representative money:

(a) Convertible Paper Money : It refers to the currency notes which are freely convertible into full bodied money (gold or silver) at any time.

(b) Inconvertible Paper Money: It is that kind of paper money which cannot be convertible into full bodied money at the option of the holder. However, it circulates & commands value as its issue is regulated by a responsible government. It means this money does not have any backing of standard coins or gold.

e.g. Indian one rupee not is good example of inconvertible paper money.

(iii) Credit Money: Credit money refens to the money value whose intrinsic value (as a commodity) is much lower than its face value

Le., Money value> Commodity value. Credit cards, bank Deposits are examples of credit money.

Forms of Credit Money

(a) Token Coins: These refer to small coins of various denominations, which are issued to facilitate day-to-day requirements.

Example: Coins of Rupee 1, 2, 5 & 10 since there value as a money is more than value of metal they made off.

(b) Representative Token Money : It is 100% backed & is fully redeemable in some commodity such as gold or silver. It is generally in the form of paper & Market value of what is actually offered is less than value printed on paper notes.

(c) Circulating promissory notes issued by Central Bank: These are currency notes issued by Reserve Bank of India (RBI). These include currency notes of denominations like Rs. 2000, Rs. 500, Rs. 200, Rs. 100, Rs. 50, Rs. 20 & Rs. 10. Each promissory note contains the words, "I promise to pay the bearer the sum of Rs......."& is signed by the Governor of the RBI. The money value of promissory notes is much higher than their commodity value..

(d) Demand Deposits in Banks: Deposits are claims of creditors. These Deposits can be withdrawn from the bank or transferred from one person to another by issuing a cheque. Such deposits do not have backing in terms of any bullion (gold or Silver). The commodity value of cheque is much lower than its money value.

GRESHAM'S LAW

Introduction

This law was propounded by Sir Thomas Gresham (1519-1579) who was a financial Advisor to Queen Elizabeth-I in Britain in the 16th century. With a view to reform the currency system, the Queen tried to replace bad coins of the previous regime by issuing new full-weighted coins. But to her dismay, as soon as new coins were put in circulation, they disappeared & as such old coins continued to remain in circulation. Queen Elizabeth Bought the advice of Sir Thomas Gresham, who provided his explanation in the form of law which states.

Statement of the law

"Bad Money tends to drive good money out of circulation.

" This principle is known as Gresham's law.

Explanation of the law

The term "bad money" does not mean counterfeit coins. It means worn out, clipped or underweight coins. When "bad money"&"good money" are both in circulation people will use the 'bad money' when making purchases & the 'good money' will be hoarded. The natural human tendency is to retain the better coins & pass on into circulation the comparatively old & worn out coins.

In ancient times, when coins made of gold & silver used to be in circulation, the full weight coins were often melted down for making jewellery & for sale to foreigners by weight. In course of time the entire shock of "good money" might be driven in this way, so that only "bad money" remained in circulation.

In Modern times, full weight metallic coins are not used. But the Gresham's law operates in subsidiary coins & as between new notes & old & soiled notes. People generally try to keep fresh notes & shining notes/coins in their pockets & pay out the soiled notes & worn out coins.

Thus bad money drives good money out of circulation.

Marshall put the law in a general form as :

"Gresham's law is that an inferior currency, if not limited in amount, will drive out the superior currency."

Good money disappears from circulation through the following ways:

(a) Hoarding: People hoard the good money & pass out the bad. There is a natural tendency to retain good coins. When payments are being made the comparatively less valuable money will be issued out first. Hence, good coins tend to remain out of circulation.

(b) Melting: If the good money is a coin, the good coins will be melted down & sold as bullion. The melting of good money is highly profitable under bimetallism.

Example: Let us suppose that Govt. ratio between gold & silver is 1 : 16, while the market ratio is 1:17. In this case, gold coins will be official undervalued & silver coins overvalued. Gold coins will be good money & Silver Coins will be bad money. By melting down 1 ounce of gold coin & selling it as bullion, a person will get 17 ounces of silver in the market. By taking 16 ounces of silver to the mint he will get an amount of silver coin in exchange of which he will again secure an ounce of gold coin.

Thus, he will make a clear profit of one ounce of Silver. The process will be repeated & all gold coins will disappear. Similarly, if gold becomes over valued, gold coins will be bad money & all silver coins will be melted down.

(c) Export to Foreign Countries: The coin of one country is not legal tender in a foreign country. Hence, foreigners will not accept it as coin but only as bullion. Thus, bad coins circulate as legal tender in the home country & good coins if they are standard money are exported as bullion to foreign countries. This is especially the case under bimetallism because the metal which is undervalued in the home country has necessarily a higher value in a foreign country.

Law in general form

Gresham's law, in its original form, applies only to debased coins of monometallic system. But it can be extended to all form of monetary standards.

Monometallism: Under monometallism (Gold Standard) the old & worn out coins are regarded as bad coins & full-weight coins are considered as good coins. According to Gresham, the old & worn out drive new & full-weight coins out of circulation.

Bimetallism: Under Bimetallism (a system of gold & silver coins) coins of over valued metals are considered bad money & coins of undervalued metal as good money. According to Gresham, the over-valued coins will drive undervalued coins out of circulation.

Paper Standard: Under paper standard (when standard coins of superior metal & inconvertible paper notes are in circulation) the metallic coins will be good money & paper notes will be bad money. Thus paper notes will drive out standard coins from circulation.

Conclusion: In Nutshell, we can say that Gresham's law is a general law which can be applicable in different forms of monetary standards.

Limitations :

(i) If the total money in circulation, including both good & bad money, exceeds the actual monetary demand of the public.

(ii) If the public is prepared to accept & circulate bad money.

(iii) If the good money is full-bodied legal tender whose face value equals its intrinsic value.

(iv) If the total supply of bad money is sufficient to meet the total monetary demand of the public.

With managed paper standard in circulation along with token coins, Gresham's law is only of limited validity in modern times.

ROLE OF MONEY IN MIXED & DEVELOPING ECONOMIES

There is no doubt that money facilitates & motivates all economic activities related to consumption, production, Exchange & distribution. Money enables a consumer to maximise his satisfaction.

Mixed Economy is that in which there is co-existence of Public & Private Sector. Both the sectors work together for the overall development of the economy. The economy which is striving hard for development is known as developing economy. Indian Economy is the best example of Mixed & Developing Economy

Money plays a significant role in overall development of Indian Economy. Following points highlights the role of money:

(A) Money Eliminates the Problem of Barter System: The two major problems that confronted the people under barter system were (i) Double Coincidence of wants (ii) Measure of value.

Now with the advent of money, these problems were eliminated because :

(i) Money is generally accepted as medium of Exchange.

(ii) Money measures the value of goods & services.

With the help of money people can buy & sell any commodity without facing the problems of double coincidence of wants. As regards the problem of measuring the value, the value of each & every commodity is given in terms of money.

(B) Money works as factor of Production: In addition to traditional four factors of production, viz., land, labour, Capital & Entrepreneurship, Money is also regarded as factor of production.

As walter puts it, if a modern economy was some how deprived of the monetary mechanism & driven back to a system of barter, the level of output will be much lower & variety of goods & services much smaller than is enjoyed with a money system. Therefore, money serves as a factor of production enabling output to increase & diversify.

(C) Money Accelerates the Pace of Production & Growth: Money as a medium of Exchange accelerated the speed of production. Money facilitates production by stimulating savings & Investment. It gives mobility to capital & helps in capital formation. Money accelerates the production process in two ways: (a) By making the factor payment quick & efficient.

(b) By making sale of output speedy & efficient.

Thus money plays a significant role in determining employment, income & output.

(**D) Money is the Life blood of a Modern Economy:** An economy remains alive & work efficiently so long as money keeps circulating in the economy. It enables the harnessing of various factors of production so that the entrepreneurs are able to maximise their profit. Money functions as a common denominator for the distribution of social product. It is in terms of money that wages, rent, interest & profit are determined. Thus, money is extremely valuable social instrument which has largely contributed to the growth of national wealth & social welfare.

(E) Miscellaneous Contributions of Money: Money facilitates the working of an economy in many other ways too:

(i)It facilitates consumers' choice in the multitudes of goods & services.

(ii) Money facilitates exchange & helps in the development of trade & commerce both national & international.

(iii) With the advent of money, a money market & credit market system have evolved.

(iv) Growth of the financial system has created an efficient system of financial flows to various sectors of the economy.

(v) Deficit financing is possible only with money.

Conclusion: In Nutshell, we can say that money plays a crucial role in a mixed economy. It helps in determining employment, output & income in the private sector. In the public sector, it is helpful in the allocation of resources & for changing the pattern of income distribution. It is powerful instrument for capital formation & economic development in a developings economy.

DANGERS OF MONEY

Money is a good servant but a bad Master. Money has proved dangerous in several ways.

(i) Economic Instability

(ii) Economic Inequalities

(iii) Moral Depravity

Characteristics of a good money or an ideal Money :

Following are the characteristics of a good money:

(i) **Stability**: A good money must achieve stability in the value of money. Value of money has two aspects-Internal & External. So an ideal money must be capable of maintaining both internal price stability & exchange rate stability.

(ii) **Elasticity**: A good money is one which covers to the needs of commerce & industry. Supply of money should be elastic so that money in circulation may expand in the busy season & contact in slack season. If money supply is adjusted to the requirements of the economy, pice stability will be maintained.

(iii) **Economical**: Money must be economical. Medium of exchange should be cheapest possible consistent with the other requirements of an ideal money. For example, Managed paper currency standard is most economical.

(iv) **Public Confidence**: A money must create confidence in the minds of the people. It must have general acceptability. Thus, money should be readily acceptable.

(v) **Intelligibility**: The money must be simple enough so that a common man may easily understand its features & importance. Moreover, its management should be simple so that cost of maintenance may be minimum.

(v) **Durability**: Money should possess the quality that it does not wear out quickly. This may to some extent to be problem with paper money.

(vii) **Divisibility**: It should be possible to divide money into smaller units so as to facilitate a variety of transactions.

(viii) **Portability**: Money should be easily transported. In modern banking systems. Money can be transmitted electronically even between very distant places.

Qualities of an Ideal Money Material

1. **General Acceptability:** It is very essence of money. In order to possess general acceptability, a commodity should have some intrinsic utility independent of its value for monetary purpose. Gold & Silver are generally acceptable to all without hesitation because they are used for ornamental & other purposes & can be easily used for monetary purposes.

2. **Portability**: A commodity fit to be used as money must be such that it can be easily and economically transported from one place to the other.

3. **Indestructibility or Durability**: As money is passed from hand to hand & kept in reserve, it must not easily deteriorate, either in itself or as a result of wear & tear.

4. **Homogeneity**: All portions or specimens of the substance used as money should be homogenous i.e., of the same quality, so that equal weights have exactly the same value.

5. **Divisibility**: The money material should be capable of division & the aggregate value of the mass after divison should be almost exactly the same as before.

6. **Malleability**: The money mateial should be capable of being melted, beaten & given convenient shapes. It should be neither too hard nor too soft. It should also possess the attribute of impressionability so that it may easily receive the impressions.

7. **Cognizability**: By cognizability, we mean the capability of a substance for being easily recognised & distinguished from all other substances. As medium of Exchange, money has to be continually handed about & it will cause great inconvenience if every person receiving it has to scrutinize weigh & test it.

8. Stability of Value: The value of money should be stable.

Difference between Money & Near Money

Money

1. **Definition**: Money consists of coins currency notes & Demand Deposits of the banks.

2. **Liquidity**: Money possesses 100 percent liquidity i.e., it is perfectly. liquid or can be readily acceptable as a means of payment.

3. **Function**: Money serves as a unit of account or a common measure of value. All prices are expressed in terms of money.

4. **Use in transactions** : Money is directly used for making transactions.

5. **Income-Yielding Quality**: Money is not an income yielding asset.

Near Money

1. **Definition**. Near-Money includes the financial assets like time deposits, bills of Exchange, Govt. Securities, shares, bonds etc.

2. **Liquidity**. Near-Money lacks 100 percent liquidity i.e., it involves time cost for its conversion into money.

3. **Function**. Near money does not perform such functions. Rather, its own value is expressed in terms of money.

4. **Use in transactions .** Near money is an indirect medium of exchange. It has to be first converted into ready money & then used for transactions.

5. **Income yielding Quality.** On the contrary, Near Money assets are income-yielding.

Money: Definitions & Functions of Money

Money can be defined as any commodity that is generally accepted as medium of exchange & a measure of value.

According to D.H. Robertson, "Anything which is widely accepted in payment for goods or in discharge of other kinds of business obligations."

According to Crowther, "Anything that is generally accepted as means of exchange & that at the same time acts as measure & as a store of value."

According to H. Withers, "The stuff with which we buy & sell things."

Functions: Money has performs the following functions:

(A) Primary functions: Primary functions includes the following functions of money.

1. Medium of Exchange Most important & unique functions of money. Money functions as a medium of Exchange between any two goods. The importance of this function lies in that it has solved one of the biggest problems of barter system. In the barter system, for exchange to take place, there must be 'double coincidence of wants."

The uniqueness of the medium of exchange function of money comes from certain unique merits of money:

(a) General acceptability.

(b) Easy portability.

(c) Divisibility

(d) Difficult to Counterfeit.

(e) Value guaranteed by the govt.

Legal enforcement as mode of compensation.

2. Money as a Measure of Value: The Second primary function of money is that it works as the measure of value of goods & services. All value are measured in terms of money. As a measure of value, money pin a couplet thus : "Money is a matter of functions four,

A medium, a measure, a standard, a store."

3. Money as a Means of Transferring Value: This is also another function which money performs. One can selow's immovable & movable belongings at one place & the money so acquired he can buy them elsewhere. Thus, money transfers possession from one person to other.

(B) Secondary Functions: Following are three functions of Money.

(i) Standard of Deferred Payments: Money also serves as a standard of payments made after a lapse of time. Lending & borrowing therefore must take place in terms of commodity which will reasonably keep its value stable over time. By serving as a standard measure of payments over time, money makes borrowings and lending much less risky. Thus, it helps in stimulatings all kinds of economic activity which depends on borrowed money or credit.

(ii) Money as a store of Value: Money serves as a store of value. it enables a person to keep a portion of assets liquid. Liquid assets are those which can be used for any purpose at anytime one likes. Function of money have been summed.

(iii) Giver of Generic Value of Capital & Wealth: Money gives a generic value of all forms of capital & wealth.

(iv) Distributor of National Income: Another most significant function of money is that it serves as a distributor of the joint goods of industries & the national dividend of the country.

(C) Contingent Functions: Besides Primary & Secondary functions of money,. Prof. Kinley also gives the four contingent functions of money :

(i) Basis of Credit: The first important contingent function of money is that it serves as a basis of credit. It is on the basis of cash reserves that bank can expand credit & issue bank notes. These reserves inspire the confidence of the people in the financial soundness of banks & give strength & stability to the country's credit & fiduciary money system.

(ii) Equalising Marginal Utilities: The introduction of money has been of immense value to both the consumer & the producer. Money works as a common denominator, as a unit of account. Infact, Money makes computation of national income possible. In the absence of money, measuring value would be an extremely difficult proposition in a modern economy.

(D) Static & Dynamic Functions

Paul Einzig classifies the functions of money as :

(a) Static functions: Static functions are those mentioned above viz., servings as medium of Exchange, measure of value, a standard of deferred payments, store of value & transfer of value.

(b) Dynamic functions: The Dynamic functions of money are those by which money influences the working of the economy by influencing price level, level of consumption, volume of production & distribution of wealth in the economy. The Dynamic functions thus determine the economic trends.

UNIT 2: Price Index Numbers and Theories of Mon

Meaning of Index Numbers

An Index number is a statistical measure designed to measure changes in a group of related variables with respect to time, geographical location or other characteristics. Index number helps us to find out the percentage change in the values of different variables over time with reference to some base year which happens to be year of comparison.

Features or Characteristics of Index Numbers

Following are the important characteristics of Index Numbers.

(a) Measure of Relative Change: Index numbers measures relative or percentage changes in the variables over time.

(b) Quantitative Expression: Index numbers offer a precise measurement of the Quantitative change in the concerned variable.

(c) Average: Index numbers show changes in terms of averages.

For instance, when it is said that, prices have risen by 7 percent between the years 2012 and 2017, it implies that prices of various goods & services on an average rise by 7 per cent.

Types of Index Numbers

Following are the important types of index numbers:

(i) Price Index Numbers: Measure changes in price over a specified period of time. It is basically the ratio of the price of a certain number of commodities at the present year as against base year.

(ii) Quantity Index Numbers : Quantity Index numbers are the indices pertain to measuring changes in volumes of commodities like goods produced or consumed etc.

(iii) Value Index Numbers: Value Index numbers are pertaining to compare changes in the monetary value of imports, exports, production & consumption of commodities.

Price Index

* Purpose of constructing index number of prices is to know the relative change or percentage change in price level over time.e.g.:

* Whole sale price Index (WPI) Consumer Price Index (CPI)

Quantity Index

*Purpose of constructing Index number of Quantity is to know relative change or percentage change in the Quantum or volume of output of different goods & services over time.

e.g.:* Index of Industrial Production (IIP)

* Index of Agricultural Production (IAP)

* Index of Export-Import (IEX)

Other types of Index Numbers

(a) Simple Index Numbers.

*These are index numbers in which all items of series are accorded equal weightage or importance.

*It will be simple average of prices of different goods & services.

* Construction of Simple index numbers can be done by using two methods:

(i) Simple aggregative method.

(ii) Simple Average of Price Relative Method.

(b) Weighted Index Numbers

*These are index numbers in which different items of the series are accorded different weight age, depending upon their relative importance.

*There are two methods of constructing weighted index numbers as discussed below :

(i) Weighted average of Price Relative Method.

(ii) Weighted Aggregative Method.

Wholesale Price Index (WPI)

* WPI measures changes in prices at the wholesale level.

In WPI, the goods are classified into 3 broad categories.

(a) Primary articles (Food & non food items)-102 commodities.

(b) Fuel & Power-19 Commodities.

(c) Manufacturing items-555 items.

WPI does not include services, it takes into consideration only goods.

Consumer Price Index

*CPI measures pice changes at the consumer price level at retail prices.

*In CPI, the goods & services and classified into 5 categories

(a) Food & beverages

(b) Fuel & light

(c) Housing

(d) Clothing, bedding & footwear.

(e) Miscellaneous groups include services

*CPI includes both goods and services.

Thus, Index numbers indicate change in real income.

Steps in Construction of Price Index Numbers

An Italian, Giovanni R. Carli is generally Cedited with inventing Index numbers. He has prepared a price index for 1750, taking 1500 as base year. In the construction of index numbers, a base year is selected & prices of a group of commodities in that year are noted. The index number for the base year equals 100.

Following are important steps involved in the construction of Index numbers.

(a) Purpose of Index Number : Before constructing an index number, it should be decided the objective for which it is being constructed. An index number constructed for one purpose cannot be used for fulfilling other purpose.

For example if we want to measure the value of money in terms of prices of goods & services, we construct consumer Price Index (CPI)

(b) Selection of Commodities: The choice of the commodities whose prices are to be taken into consideration depends upon the purpose of constructing index number. It is neither possible nor desirable to include all the goods & services produced in the country. We have to choose those goods & services which represents most of others in the market.

In India, while constructing WPI, 676 commodities are taken into consideration for construction WPL.

(c) Selection of Base Year: Selection of Base year is another problem in the construction of index number. Base year is the reference year. It is the year with which price of the current year are compared. As far as possible, Base year should be a normal year.

(d) Selection of the Prices of Goods & Service: Having selected the goods & services, the problem arises of prices to be selected. Broadly, in the construction of Price Index, the problem is to whether to adopt retail prices or wholesale price controlled or opened market prices. The choice would depend upon the objective or purpose of the study.

(e) Selection of the Average: Since price-relatives for some commodities might be lower than 100 and for others higher than 100, it becomes necessary to work out average of all the price relatives. Different methods can be adopted for average. Irring fisher has mentioned 96 main & 38 supplementary formulae that give correct results within a fraction of one percent.

(f) Assigning proper weights: The Index number may be simple or weighted. Simple index number is based on the assumption that all the commodities are of equal importance. But practically, it is not so. In order to express the relative importance of different commodities, weights are assigned to different commodities according to their importance in the scheme of consumption. Weighted index number is arrived by multiplying the price relatives by the weights assigned to individual commodities.

(g) Selection of formula : Index numbers can be constructed with the help of many formulae such as,

• Laspeyre's Method

*Paasche's Method

* Dorbish & Bowley's Method

*Fisher's Method

One has to decide about the method to be used while constructing the index number.

Difficulties in the Construction of Index Numbers

There are various Conceptual & Practical difficulties faced by statistician

while constructing the Index Number. These are explained under two heads as below:

(A) Conceptual or Theoretical Difficulties: Following are the conceptual difficulties:

(i) Basis of Comparison: The basis of comparison is based on the relative expenditure made upon different commodities. But it does not same from year on year nor the quality of a commodity remains unchanged. Its quality change over time.

(ii) Value of Money: Another conceptual difficulty faced by statistician is difficulty in measuring the value of money. The value of money is generally defined as the reciprocal of the general price level. The changes in the value of money are thus to be measured by corresponding changes in general price level over a period of time.

But the concept of general price level is itself abstract & purely theoretical. The general price level implies inclusion of all prices but practically we cannot include all the individual prices in it. We take sectional price levels only & prepare different indices for different sectional average price levels, such as wholesale price indices, cost of living indices etc. These indices reflect different changes in the value of money at different times & in different places.

(iii) Concept of General Price Level is theoretically invalid: The general price level is indicative of average prices only. A rise or fall in the general price level does not mean that the price of each & every commodity has rise nor fallen to the same extent as indicated by the general price index. Thus, it does not reflect the true position. In a strict sense, the concept of general price level is theoretically in admissible.

(iv) Difficulties in the Selection of Base year: The Base year should be a normal year. But it is difficult to determine the base year.

(v) Difficulties in the Selection of Commodities: The selection of representative commodities for the index number is another difficulty. The choice of representative commodities is not an easy matter. They have to be selected from a wide range of commodities which the majority of people consume.

(vi) Difficulties in the collection of Prices: Another difficulty is that of collecting adequate & accurate price Quotations it is often not possible to get them from the same source or place. Further, the choice between wholesale & retail price arises has to be made.

(vii) Arbitrary Assigning of Weights: In calculating weighted price index, a number of difficulties arise. The problem is to give different weights to commodities. The selection of higher weight for one commodity & a lower weight for another is simply arbitrary. Moreover, the same commodity may have different importance for different consumers. The importance of commodities also change with changes in tastes & income of consumers.

(B) Practical Difficulties

The construction of index numbers is beset with several practical difficulties which make it impossible to have a perfectly accurate measurement of the value of money. Some of the practical difficulties are mentioned below:

(i) The Index Number Problem: The first & foremost important difficulty arise in construction of Index number relating to decision of representative commodities & weights has been termed as 'the index number problem. It is well known fact that all classes of people living in a particular country do not have the same basket of commodities. Their purchases are according to their tastes needs, habits & income. It is not essential that the same commodities were consumed in the year i.e. year of comparison.

(ii) Difficulty in finding Average: In finding out average values, different kinds of average may be used, geometric average, arithmetic average etc. The choice of average generally affects the results. Different kind of averages may give different index number of a given change in price.

(iii) Difficulty in Selection of Formula : Index numbers can be constructed with the help of many formulae such as, laspeyre's method, paasche's method, fisher's method etc. One has to decide which method is to be used.

Significance/Uses/Importance of Index Numbers

Some of the important uses/advantages of index numbers are as under :

(a) Measurement of Change in the price level or value of Money: Most important use of index numbers is that index number measure the value of money during different periods of time. We come to know the impact of change in the value of money on different sections of the society.

(b) Knowledge of the Change uses in Standard of living: Index number help to ascertain the living standards of people. Money income may increase if index numbers show a decrease in the value of money, living standards may even decline purchase the same basket of commodities their purchases differ according to their needs, tastes, habits & income. It is not essential that the commodities which were consumed in base year, will be consumed in the base year.

(c) Adjustments in Salaries & Allowances: Cost of livings index is useful guide to the Govt. & Private Enterprises to make necessary adjustments in salaries & allowances of the workers.

(d) Useful to Business Community: Price Index numbers serve as a useful guide to the business community in their planning & decisions. Trend of prices significantly influence their production decisions.

(e) Information Regarding Production: Index numbers of production shows whether the level of agricultural & industrial production in the economy is increasing or decreasing. Accordingly, agricultural and industrial development policies are formulative.

(f) Useful to Politicians: Politicians come to know the real economic conditions in the country on the basis of index numbers. They offer constructive criticism of govt. economic policies & give suggestions for economic reforms in the country.

(g)Useful of Government: Index numbers are helpful to the govt. in determining monetary & fiscal policies & takes concrete steps for the economic development of a country. Government, formulates appropriate policies to increase investment, output, income, employment, trade, price level, consumption etc.

(h) Information regarding foreign trade: Index of Exports & Imports provides useful information regarding foreign trade.

THE CASH TRANSACTIONS APPROACH-FISHERIAN VERSION

Prof. Irving Fisher in his book "The Purchasing Power of Money (1911), tried to provide a formalistic expression to the direct relationship between the Quantity of money supply & general level of prices. Fisher held that the general price level varies directly with Quantity of Money (or money supply).

He proves with the help of equation of exchange as follows:

Equation of Exchange

It is a monetary equilibrium identity started by Fisher as under

MV = MT

Where, 'M' represents the total quantity of money, 'V' is the velocity of circulation of money, i.e., average no. of times each unit of money is spent for the purchase of goods & services during a given period.

'P'-represents the general price level.

"T-refers to the total volume of transactions.

Thus the product 'MV' gives the aggregate effective supply of money (or the total money expenditure during a given period & 'PT' is the money value of all the things bought during a given period it gives demand for money.

The equation of Exchange is also referred to as the cash transactions equation.

Fisher's Exposition of Quantity theory of Money

In his equation MV=PT, Fisher stated P= MV/T which implies that the quantity of money (M) determines the price level (P) & the latter varies directly in proportion to the changes in the stock of money, assuming 'T' & 'V' to be constant.

In this equation of Exchange, only primary/currency money is conceived. But in modern economy, money includes not only notes & coins but also demand deposits of banks or credit money.

Thus, the extended form of the equation of Exchange is written as:

P= MV+M'V' /T

Price level is determined by the following factors:

The quantity of money in circulation (M).

The velocity of circulation of money (V).

The volume of bank money (M).

The velocity of circulation of bank money (V).

The volume of trade or transactions, i.e., the amount of goods bought by money (T).

The equation further denotes that the price level (P) is directly related to M, V, M' & V' & it is inversely related to T.

Assumptions in Fisherian Analysis:

(i) **The Price level (P) is a passive variable:** It is determined & controlled solely by the other elements is the equation.

(ii) **The total volume of transactions (T) is an independent but constant variable in the short run:** 'T' depends upon natural, technological development & population etc.

(iii) **The velocity of circulation of money, V, is an independent element in the equation & is constant in the short period**: Normally, any change in 'M' has no effect on V, for it depends upon outside factors such as payment habits of individuals & Commercial customs, density of population & development of transportation.

(iv) **The Ratio M' is constant**: The magnitude of bank money (M') depends on the commercial banks credit creation activity which in effect is a function of currency money (M).

(v) **Full employment**: Assumption of full employment condition in the economy is implicit in the fisherian analysis.

(vi) **Short Period Analysis:** Fisher categorically viewed this theory on the basis of short period consideration of changes in the variable like M, V,P&T held V&T to be constant elements in his equation of Exchange.

Criticism:

The Fisherman approach has been severly criticised as under:

(a) The Equation of Exchange is just a mathematical truism: The equation of exchange by itself provides no analytical due to the determinants of the value of money. It is mathematical identity, MV = PT, revealing that the turnover of money is always equal to the turnover of goods i.e., money paid equals money received. Hence, the cash transactions equation is a truism or a self evident proposition.

(b) The Price level (P) is wrongly assumed to be passive factor: The price level 'P' is not passive as assumed by fisher. In reality, P may be active. P does influence T, because rising prices give profit incentives to business expasion, would increase, thus, a rise in P may increase the volume of trade which may cause increase in the Quantity of Money & V.

(c) **The velocity of circulation of Money (V) may not be a constant factor :** Fisher regards V as independent & constant. But in practice 'V' may vary with volume of trade & Price level.

(d) The Fisher approach is mechanical & lacks human touch: Fisher's explanation is mechanical because the theory gives an impression that the price level can be controlled by regulating the variables in the equation. In equation, there is no scope for decisions of consumers & producers about saving & investment. The human element is absent in the equation.

(e) The transactions approach of the Quantity theory of Money is one sided : It considers the supply of Money as most effective & assumes the demand for money to be constant there by neglecting the forces of demand for money, causing changes in the value of money.

The Cash Balances Approach: Cambridge Version

Cash Balance Approach was propounded by the Cambridge Economists. Marshall, Pigou, Robertson & Keynes.

According to Cash Balances Approach: The value of money depends upon the supply of & Demand for Money. The basic postulate of the CBA is that community's demand for money or cash-balances, induced by transactions & precautionary motives constitutes a certain proportion of its annual real national Income which the community desires to hold in the form of money.

The Relation between the supply of & the demand for money so conceived is exposed by the advocates of CBA, by formulating equations, also known as Cambridge Equations.

(A) The Marshallian Equation: Among all Cambridge Economists, Marshall pioneered the cash balance theory. His equation is expressed as:

M= KPY

where 'M' stands for quantity of money (currency + DD)

"P"-Price level

"Y" denotes Aggregate Real Income.

'K' is fraction of real income which people desire to hold in the form of money.

$P=KY/M$

(Here, P represents purchasing power)

It follows that KY remaining unchanged, when M increase P, the purchasing power of money, decreases. Marshall also shows that 'M' & 'Y' being constant, P improves with the increase in K. In his view, K is more important than M.

where

'c' is proportion of cash which people keep as legal tender.

1-c' implies the proportion of bank balances held by the people.

'h' is the proportion of legal tender to deposits held by banks.

In above equation 'k', 'c' & 'h' are all positive constants being less than 1 but more than zero i.e..

$0<k<1$

$0<c<1$

$0<h<1$

COMPARSION BETWEEN FISHERAIN & CAMBRIDGE APPROACHES

There are certain points of similarities between Fisher's transactions approach & the Cambridge cash Balances approach. These are discussed as under:

Similarities

The two approaches have gross resemblances of similarities as under : (a) Identical Hypotheses: Both the theories of quantity theory of money conclude that price level or value of money depends upon the Quantity of Money. (6) Similar Equations of Fisher & Robertson

Fisher's equation

$P = M/KT$

Roberston's equation

$K = M/PT$

Both the equations contain the same symbols, meaning almost the same thing. The only apparent diference lies in V &K . But infact K&V tends to be reciprocals of $K = 1/V$ * or $V = 1/K$ each other because Thus, two types of equations emphasise simply different aspects of the same phenomenon.

K is an index of demand for money as store of value, V is velocity of money indicating the rate of spending.

(c) Different Angles of the same Phenomenon: While the transactions version emphasis velocity of circulation of money (V) considering money as a flow, the cambridge version puts stress on cash balances (K) regarding money as a stock, both Ultimately considering the function of money as a medium of exchange. Robertson, therefore states that the two types of equations are really different observations of the same phenomenon the cash balance approach is concerned with 'Money sitting' & the transactions approach with 'Money on the wing'.

Dissimilarities or Contrasts

1. Differences in the concept of Money Supply: The Cash balance Model consider money as a stock concept while transactions approach consider money as a flow concept.

2. Differences in the concept of Demand of Money: The fisherian version emphasises on the medium of Exchange function of money while the cambridge version stresses the store of value function of money.

3. Mechanistic Approach vs. Realistic Approach: Fisher's equation is Mechanistic in the sense that it does not explain how changes in the volume of money bring about changes in the price level. While cambridge equation is realistic & takes into account the human factor.

4. Differences in Approach & Emphasis on 'V' vs 'K': Fisherian approach stressed the spending aspect, cambridge economists emphasised the holding aspect of money. Therefore 'V' is significant for fisherians & 'K' is important in the cambridge approach.

SUPERIORITY OF CAMRBRIDGE VERSION OVER-FISHER'S VERSION

The cash balances approach represents on advance over the cash transactions approach in many aspects:

(a) Humanistic approach: The cambridge equations emphasise 'K' or cash balances & consider human motives as important factors affecting the price level, as opposed to the mechanistic nature of cash transactions equation.

(b) Better mode of thinking: The cambridge version is concerned with the level of income as against fisherian consideration of the total number of transactions. This notion has paved the way for a new mode of thinking in modern economies.

(c) Integration of the theory of Money with General value of Money: Fisher's approach is only one-sided in the sense that it considers supply of money to be the only effective element in determining the value of money. The cambridge equations are stated interms of supply 8 demand of money.

(d) More Realistic Approach: The cash balances equation emphasises the psychological factors or subjective valuations as chief determinants of the demand for money. On the contrary, fisherian version approach which stresses the institutional, objective & technological factors only. Thus, cambridge version is more realistic.

(e) Foundation of Modern theory of Interest & Demand for Money: The Cambridge Approach has sown the seeds of the keynesian liquidity preference theory of Interest as well as modern concept of demand for money. It points out two of the three liquidity motives, viz., the transactions & precautionary motives.

UNIT-3: Commercial Banks

MEANING OF COMMERCIAL BANK:

A commercial bank is that financial term institution, which accepts deposits from the people and advance shorts, medium loans to the individual and purpose of consumption or investment. Besides, commercial banks in modern time these days perform various other functions such as credit creation, transfer of funds, agency jobs and general services. Credit creation function of commercial banks generate a may is portion of money supply in the economy.

According to Indian Banking Companies Act, Banking company is one which transacts the business of banking which means the accepting deposits for the purpose of lending or investment from the public repayable on demand or otherwise and withdrawal by cheque, draft, order or otherwise."

According to Prof. Kinley, "A bank is an establishment which makes to individuals such advances of money as may be required and safely made, which individuals entrust money or means of payment when not required by them for use."

TYPES OF BANKS IN INDIA

1. Central Bank: RBI was set up in 1935 (by the RBI Act 1934 on the recommendation of Hilton Young Commission. It is the apex body that is in control of the banking system in India. It is the regulatory authority that supervises and controls the operations of the banks and non-bank financial institutions with the aim of maintaining a sound financial system and a credit system conducive to growth and stability of the economy The RBI as the apex bank in the country acts as a banker to all scheduled banks in the economy and as the banker to the government. Its role as an adviser to the government as well as the banks on economic and financial issues has elevated the central bank to height where tests in a position of respect and reliance.

2 Commercial banks: The central bank deals with the government and other banks as the controlling authority. Among the banks that deal with the people in general, the commercial banks have the largest network to serve the public at different levels from small savers to large investors. These banks accept deposits and advances leans. Many big commercial bank network have specialized wings to function as other forms of banks like development and investment banks and even as EXIM banks. The commercial banks are one of the most important units of the banking system in the country, It plays an important role in creating credit that produces a multiplier effect in enhancing the money supply in the economy.

3. Investment bank: These banks are specialized to help businesses to raise capital by selling share of the companies or by purchasing the shares from the companies and reselling them to the public. These banks acts as a bridge between the issuers of securities and the investors. They also pay advisory roles to the business firms by providing consultancy services. To provide several other services other services such as providing loans to firm for purchasing assets or for mergers, trading of securities, advisory services in case of merger, and acquisitions Examples of investment banks in India are Bank of America, Citigroup Investment Banking, JP Morgan, Deutsche Bank and Barclays Capital Many commercial banks have their own investment banking wings as well.

4. Development banks: Development banks are specialized financial institutes that cater the development needs of the country to general and for the industries in particular. They are term lending institutions that provide long and medium-term loans to the industrial units. They does not accept deposits from the public. These banks are focused toward economic development by channelizing resources investment to boost industrial activity that is strategic to the growth of the economy . It caters to both the private and the public sectors. Industrial Development Bank of India (IDBI). Small Industries Development Bank of India (SIDBI), and State Finance Corporations (SFC) are some examples of development banks operating in India.

5. Agricultural banks: Agriculture has been given special emphasis in India as a major part of the population Directly or indirectly is engaged in agriculture. Thus, agricultural development is pivotal to the overall economic development in the country among the various functions of the RBI development of agriculture was also a part of responsibilities entrusted to the apex bank, which demonstrates the importance that the policymakers attached to agricultural finance The RBI carries out its agricultural credit and refinance functions through the Agricultural Refinance and Credit Corporation (ARDC). In 1982, the functions of the ARDC were transferred to an independent credit and refinance organization, the National Bank of Agriculture and Rural Development (NABARD) . The objective of NABARD was to set up institutional credit system in the rural areas to bring about sustainable agricultural development and foster rural prosperity.

6. Cooperative Banks: These are banks that have been formed under the cooperative societies act and mostly operate in the rural areas through there are a number of urban cooperative banks as well. These banks are cooperative organizations run by the members who have voting rights in the policy decisions of the bank. These banks are controlled by the Registrar of Cooperative Societies The depositors are members of the cooperative who can take loans on a low rate of interest. In India, there are a number of State Cooperative Banks, District Cooperative Banks, Scheduled Cooperative Banks, and Non-Scheduled Urban Cooperative Banks with three ties system.

7. Regional rural banks (RRBs):RRBs were formed in India with the objective of meeting the financial needs of the small and marginal farmers, agricultural labourers. Rural artisans, and other sections of the rural society that require credit support. The Regional Rural Banks Act, 1976, paved the way to the formation of the RRBs with a mission to develop the rural economy.

8 Export-Import Bank (EXIM Bank): The EXIM bank of India was set up in 1982 11 is wholly owned by the government of India. It provides financial assistance to exporters and importers. It also coordinates the working of financial institutions engaged in financing exports and imports of goods and services.

9. Exchange banks: These banks deal in foreign exchange Merchants and trailers who require foreign exchange for their business operations may obtain credit from these banks in foreign exchange. Some forex banks in India are ABN , AMRO Bank NV Bank of India, HDFC Bark, State Bank of India, and such others.

10 Micro units development bank: The Micro Units Development and Refinance Agency (MUDRA) was set up in March 2015 under the Pradhan Mantri Mudra Yojana. The objective of this scheme is to promote micro enterprises. The scheme aims at developing skilled and educated young workers and entrepreneurs who can develop and manage their own micro enterprises.

CREDIT CREATION BY COMMERCIAL BANKS

Creation of credit is one of the important functions of commercial Banks. A bank has sometimes been called a factory of credit. It is an open secret that the banks do not keep cent per cent reserves against deposits in order to meet the demands of depositors. It is generally understood that money received by the bank is meant to advanced to others. A bank's demand deposits arise mainly from:

(a) Cash deposits by customers-Primary Deposits.

(b) Banks loans & Investments-Derivative Deposits.

Primary Deposits serve as a basis for creating derivative deposits, that is, credit creation and for increasing money supply. Commercial Banks are profit seeking institutions & they find from their past experience that a large volume of cash deposits through primary deposits lie idle because all such demand deposits are not withdrawn at the same time by their customers, they use these resources for advancing loans.

Credit Creation by Banks: Balance Sheet Approach:

A simplified hypothetical example is given here to illustrate the process by which multiple credit expansion by Commercial Banks take plan.

We illustrate how deposit of ₹1,00,000 of cash in a commercial banks enables the banking system as a whole to expand deposits by another ₹4,00,000, that is, deposits of ₹1,00,000 in curency leads to total deposits of ₹5,00,000 in the banking system. A simple balance sheet has two columns, its left column represent all the assets of a bank & its right column represents all the liabilities of a bank.

Let us suppose that an individual or a firm deposits ₹ 1,00,000 in cash with a bank. The cash of ₹1,00,000 which the bank 'A' will receive become its assets & at the same time individual's deposits of ₹1,00,000 will be its liabilities, the assets & liabilities of bank 'A' therefore be equal to each other.

Banking Sector Reforms Since 1991

After the introduction of new economic reforms of 1991, the Govt. of India has introduced many reforms in Indian Banking system & banking system has undergone drastic transformation through several development reforms & policy measures intoduced. With a view to strengthen the banking system, to provide them operational autonomy & flexibility to the banks, to address structural issues of banking sector & to create international competitive environment for the improvement in productivity of banking sector, Govt. has undertaken several reforms measures since 1991.

Following are the important reforms introduced in Indian Banking System Since 1991.

(a) Deregulation of Interest Rates: In order to provide operational flexibility & competitive environment to banks, interest rates on deposits & loans of commercial banks including urban co-operative banks have been deregulated i.e., controls & regulations of RBI on interest rate has been abolished.

(b) Reduction in Reserve Requirements: Reserve Requirements of commercial banks have been drastically reduced in order to ease the availability of liquidity for credit & to enhance the role of market forces.

Table 1: Trends in Cash Reserve Ratio (CRR)

Year	CRR (%)
1991.	15%
2008	7.50%
2018	4.0%

Table 2: Trends in Statutory Liquidity Ratio (SLR)

Year	SLR
1991	38.5%
2000.	25.0%

2012	**24.0%**
2018	**20.5%**

(c) Measures to improve the Competitive Efficiency in Banking Sector : For improving the competitive efficiency of the banking sector, all nationalised commercial banks are allowed to raise capital from equity market. Operational autonomy was given to banks. Private Sector Banks, foreign Banks were allowed to enter into banking sector. Foreign Direct Investment (FDI) & Foreign Institutional Investment (FII) were also allowed to the banking sector. New Guidelines for the ownership, mergers and amalgamation of private banks and non-banking financial institutions have been specified.

(d) Prudential Norms: In order to improve the performance of banking sector, the income recognition, assets classification, Provision for bad debts, risk concentration norms were introduced. As per RBI directives, all the Commercial Banks are to adopt uniform & sound accounting practices in above respects.

(e) Transparency Measures: For transparent banking operations, banks are required to disclose their balance sheet with detailed information as per the norms specified by International Accounts Standard Committee.

(f)Expansion of Capital Base : All the banks are required to achieve at least 8 percent Capital Adequacy Ratio (CAR) relative to risk-weighted assets ratio by March 1996.

(g) Removal of Licensing: The Govt. has allowed foreign & private sectors banks to operate & function in the system. This helps in creating a competitive environment for all the banks.

(h) Supervision of Commercial Banks: A board for financial Supervision was established by RBI. To assist the board, a department of Supervision in RBI was created. The Board of financial Supervision & Department of Supervision were not only to look the functioning of Commercial Banks but also have to supervise the functioning of financial institutions & non-financial institutions.

(i) Asset Reconstruction Fund (ARF): A Asset Reconstruction fund was established to ensure quick recovery of loans.

(j) Banks were given more freedom to open, shift branches & extension counters.

(k) Financial support through budgetary provision was given to weak public sector banks.

(l) Restructuring the banking System: The committee recommended a four tier structure of banking system, which will comprise three or four international & large banks, 8-10 national banks with the network throughout the nation, local banks with activities in specific areas and Rural Banks whose activities are confined to rural areas.

(m) The commercial banks are now free to determine their prime leading rates (PLR) for commercial credit. PLR has been converted into a bench mark rate for banks.

(n) RBI has introduced Interim Liquidity Ajustment Facility (LAF).

(o) Based III Guidelines, 2015: The RBI released on 28th May, 2015, the guidelines on Net Stable Funding Ratio (NSFR) under Basel III framework for liquidity standards of Banks. The NSFR is defined as the amount of available stable funding relative to the amount of required stable funding.

(p) Banking Ombudsman (Lokpala): Banking ombudsman scheme was introduced by the RBI in 1995 under the Banking Regulation Act, 1949. A senior official appointed by RBI to address customers complaints against deficiency in central banking services. It has jurisdiction over all commercial Banks, RRBs, scheduled primary Co-operative Banks, NBFCs etc.

ROLE OF COMMERCIAL BANKS IN THE ECONOMIC DEVELOPMENT OF INDIA

Banks have always played an important position in the country's economy. They play a decisive role in the development of the industry and trade. They are acting not only as the custodian of the wealth of the country but also as resources of the country, which are necessary for the economic development of a nation. The general role of commercial banks is to provide financial services to general public and business, ensuring economic and social stability and sustainable growth of the economy.

Commercial Bank in India comprises the State Bank of India (SBI) and its subsidiaries, nationalized banks, foreign banks and other scheduled commercial banks, regional rural banks and non-scheduled commercial banks. The total numbers of branches of commercial banks are more than 50,000 and the regional rural banks are approximately 8,000 covering 280 districts in the country.

Commercial banks mostly provide short term loans and in some cases medium term financial assistance also to small scale units. Most of the commercial banks have got specialized units in their administrative structure to take care of the financial needs of the small scale industrial units. As we know that the Agriculture is the backbone of economy of any country like India. Research is based upon the secondary data. Which provide the findings on commercial banks and how it helpful in economic development. The main objective of the study is to critically examine and analyze the role of commercial banks on economic growth in India. The study portrays how loans and credit affect the GDP and consequently the level of economic growth of India.

Introduction

Activities of the commercial banks in India are expanding at a rapid space during the period after Independence. There is territorial as well as functional expansion of the activities of the bank. Banks which are conservative and conventional in their approach have come out from their shell and face the challenges of planned economic growth. In recent years non-conventional sectors are receiving the attention of commercial banks in India. A better understanding of the implications of financing nonconventional sector by commercial banks is possible only if one looks back the position of commercial banks during the pre-nationalization era.

Commercial Banks are is the institutions that ordinarily accept deposits from the people and advances loans. Commercial Banks also create in India; such banks alone are called Commercial Banks which have been established in accordance with the provisions of the Banking Regulation Act, 1949. Commercial Banks may be Scheduled Banks of Non Scheduled Banks.

According to Section 5(c), Banking Regulation Act, (BR Act), 1949. 'a banking company is a company which transacts the business of banking in India. According to Reserve Banks of India Act 1934, 'A Scheduled Bank is that bank which has been included in the second schedule of the Reserve Bank'.

Thus, Commercial banks form a prominent part of the country's Financial Institution System. Commercial Banks are those profit making institutions which accept deposits from general public and gives money (loan) to individuals like household, entrepreneurs, businessmen etc.

The prime objective of these banks is to earn profit in the form of interest, commission etc. The operations of all these commercial banks are regulated by the Reserve Bank of India, which is the central bank and supreme financial authority in India.

Classification of Commercial Banks

1. Scheduled banks: - Banks which have been included in the Second Schedule of RBI Act 1934. They are categorized as follows:

2. Public Sector Banks: - are those banks in which majority of stake are held by the government. Eg. SBI, PNB, Syndicate Bank, Union Bank of India etc.

3. Private Sector Banks: - are those banks in which majority of stake are held by private individuals. Eg. ICICI Bank, IDBI Bank, HDFC Bank, AXIS Bank etc.

4. Foreign Banks: - are the banks with Head office outside the country in which they are located. Eg. Citi Bank, Standard Chartered Bank, Bank of Tokyo Ltd. etc

5. Non-scheduled commercial banks: - Banks which are not included in the

Second Schedule of RBI Act 1934.

List of Commercial Banks in India

SBI & Associates:

State Bank of India.

Nationalized Banks:

1. Allahabad Bank

2. Andhra Bank

3. Bank of Baroda

4. Bank of India

5. Bank of Maharashtra

6. Canara Bank

7. Central Bank of India

8. Corporation Bank

9. Dena Bank

10. Indian Bank

11. Indian Overseas Bank

12. Oriental Bank of Commerce

13. Punjab & Sind Bank

14. Punjab National Bank

15. Syndicate Bank

16. UCO Bank

17. Union Bank of India

18. United Bank of India

19. Vijaya Bank

Foreign Banks:

1. ABN Amro Bank

2. Abu Dhabi Commercial Bank

3. American Express Banking Corporation

4. AB Bank

5. Bank International Indonesia

6. Bank of America

7. Bank of Bahrain & Kuwait

8.Bank of Ceylon

9. Barclays Bank

10. BNP Paribas

11. Chinatrust Commercial Bank

12. Citibank

13. DBS Bank

14. Deutsche Bank

15. Hongkong & Shanghai Banking Corporation

16. JP Morgan Chase Bank

17. Standard Chartered Bank

18. UBS AG

Importance of Commercial Banks in the Development of the Country

Banks are one of the most important parts of any country. In this modern time money and its necessity is very important. A developed financial system of the country ensures to attain development. A modern bank provides valuable services to a country. To attain development there should be a good developed financial system to support not only the economic but also the society. So, a modern bank plays a vital role in the socio economic matters of the country. Some of the important role of banks in the development of a country is briefly showing below.

a) Promote Saving Habits of the People: Bank attracts depositors by introducing attractive deposit schemes and providing rewards or return in the form of interest. Banks providing different kinds of deposit schemes to its customers. It enables to create banking habits or saving habits among people.

b) Capital Formation and Promote Industry: Capital is one of the most important parts of any business or industry. It is the life blood of business. Banks are increase capital formation by collecting deposits from depositors and convert these deposits in to loans advances to industries.

c) Smoothing of Trade and Commerce Functions: In this modern era trade and commerce plays vital role between any countries. So, the money transaction should be user friendly. A modern bank helps its customers to sent funds to anywhere and receive funds from anywhere of the world. A well developed banking system provides various attractive services like mobile banking, internet banking, debit cards, credit cards etc. these kinds of services fast and smooth the transactions. So, bank helps to develop trade and commerce

d) Generate Employment Opportunity: Since a bank promote industry and investment, there automatically generate employment opportunity. So, a bank enables an economy to generate employment opportunity.

e) Support Agricultural Development: Agricultural sector is one of the integral part of any economy. Food self sufficiency is the major challenge and goal of any country. Modern bank promote agricultural sector by providing loans and advances with low rate of interest compared to other loans and advances schemes.

f) Applying of Monitory Policy: Monitory policy is a important policy of any government. The major aim of monitory policy is to stabilize financial system of the country from the dangerous of inflation, deflation, crisis etc.

g) Balanced Development: Modern banks spreading its operations throughout the world, we can see number of big banks like citi bank, Baroda bank etc. It helps a country to spread banking activities in rural and semi urban areas. With the spreading of banking operations around the country, helps to attain balanced development by promoting rural areas. Modern bank plays vital role in the socio-economic development of the country. A developed banking system enables the country to attain balanced development without any special consideration of rich and poor, cities and rural areas etc.

Functions of Commercial Banks

The commercial banks serve as the king pin of the financial system of the country. They render many valuable services.

Commercial banks provide banking services to businesses and consumers through a network of branches. These banks are in business to make a profit for their owners and they are usually public limited companies managed by shareholders. In India, however, most of the top commercial banks are owned by the government. But many private commercial banks have been established in the recent years. Commercial banks are all purpose banks that perform a wider range of functions such as accepting demand deposits, issuing cheques against saving and fixed deposits, making short-term business and consumer loans, providing brokerage services, buying and selling foreign exchange and so on.

The functions of commercial banks are explained below:

A) Primary functions

1. Collection of deposits

2. Making loans and advances

1.Collection of deposits: The primary function of commercial banks is to collect deposits from the public. Such deposits are of three main types: current, saving and fixed.

i) Current account is used to make payments. A customer can deposit and withdraw money from the current account subject to a minimum required balance. If the customer overdraws the account, he may be required to pay interest to the bank. Cash credit facility is allowed in the current account.

ii) Savings account is an interest yielding account. Deposits in savings account are used for saving money. Savings bank account-holder is required to maintain a minimum balance in his account to avail of cheque facilities.

iii) Fixed or term deposits are used by the customers to save money for a specific period of time, ranging from 7 days to 3 years or more. The rate of interest is related to the period of deposit. For example, a fixed deposit with a maturity period of 3 years will give a higher rate of return than a deposit with a maturity period of 1 year. But money cannot be usually withdrawn before the due date. Some banks also impose penalty if the fixed deposits are withdrawn before the due date. However, the customer can obtain a loan from the bank against the fixed deposit receipt.

2. Loans and advances: Commercial banks have to keep a certain portion of their deposits as legal reserves. The balance is used to make loans and advances to the borrowers. Individuals and firms can borrow this money and banks make profits by charging interest on these loans. Commercial banks make various types of loans such as:

i) Loan to a person or to a firm against some collateral security;

ii) Cash credit (loan in installments against certain security);

iii) Overdraft facilities (i.e. allowing the customers to withdraw more money than what their deposits permit); and

iv) Loan by discounting bills of exchange..

B) Agency Services: The customers may give standing instruction to the banks to accept or make payments on their behalf. The relationship between the banker and customer is that of Principal and Agent. The following agency services are provided by the bankers:

i). Payment of rent, insurance premium, telephone bills, installments on hire purchase, etc. The payments are obviously made from the customer's account. The banks may also collect such receipts on behalf of the customer.

ii). The bank collects cheques, drafts, and bills on behalf of the customer.

iii). The banks can exchange domestic currency for foreign currencies as per the regulations.

iv). The banks can act as trustees/executors to their customers. For example, banks can execute the will after the death of their clients, if so instructed by the latter.

C) General Utility Services: The commercial banks also provide various general utility services to their customers. Some of these services are discussed below:

i). Safeguarding money and valuables: People feel safe and secured by depositing their money and valuables in the safe custody of commercial banks. Many banks look after valuable documents like house deeds and property, and jeweler items.

ii). Transferring money: Money can be transferred from one place to another. In the same way, banks collect funds of their customers from other banks and credit the same in the customer's account.

iii). Merchant banking: Many commercial banks provide merchant banking services to the investors and the firms. The merchant banking activity covers project advisory services and loan syndication, corporate advisory services such as advice on mergers and acquisitions, equity valuation, disinvestment, identification of joint venture partners and so on.

iv). Automated Teller Machines (ATM): The ATMs are machines for quick withdrawal of cash. In the last 10 years, most banks have introduced ATM facilities in metropolitan and semi-urban areas. The account holders as well as credit card holders can withdraw cash from ATMs.

v). Traveler's cheque: A traveler's cheque is a printed cheque of a specific denomination. The cheque may be purchased by a person from the bank after making the necessary payments. The customer may carry the traveler's cheque while travelling. The traveler's cheques are accepted in banks, hotels and other establishments.

vi) Credit Cards: Credit cards are another important means of making payments. The Visa and Master Cards are operated by the commercial banks. A person can use a credit card to withdraw cash from ATMs as well as make payments to trade establishments.

Structure of Banking Sector in India

Reserve Bank of India is the Central Bank of our country. It was established on Ist April 1935 under the RBI Act of 1934. It holds the apex position in the banking structure. RBI performs various developmental and promotional functions

Indian Banks are classified into commercial banks and Co-operative banks. Commercial banks comprise:

(1) Schedule Commercial Banks (SCBs) and non-scheduled commercial banks. SCBs are further classified into private, public, foreign banks and Regional Rural Banks (RRBs); and

(2) Co-operative banks which include urban and rural Co-operative banks.

The Indian banking industry has its foundations in the 18th century, and has had a varied evolutionary experience since then. The initial banks in India were primarily traders' banks engaged only in financing activities. Banking industry in the pre independence era developed with the Presidency Banks, which were transformed into the Imperial Bank of India and subsequently into the State Bank of India.

The initial days of the industry saw a majority private ownership and a highly volatile work environment. Major strides towards public ownership and accountability were made with Nationalisation in 1969 and 1980 which transformed the face of banking in India. The industry in recent times has recognised the importance of private and foreign players in a competitive scenario and has moved towards greater liberalisation.

In the evolution of this strategic industry spanning over two centuries, immense developments have been made in terms of the regulations governing it, the ownership structure, products and services offered and the technology deployed.

The entire evolution can be classified into four distinct phases.

1. Phase II- Pre-Nationalisation Phase (prior to 1955)

2. Phase II- Era of Nationalisation and Consolidation (1955-1990)

3. Phase III- Introduction of Indian Financial & Banking Sector Reforms and Partial Liberalisation (1990-2004)

4. Phase IV- Period of Increased Liberalisation (2004 onwards)

Organisational Structure:

1. Reserve Bank of India: Reserve Bank of India is the Central Bank of our country. It was established on 1" April 1935 accordance with the provisions of the Reserve Bank of India Act, 1934. It holds the apex position in the banking structure. RBI performs various developmental and promotional functions.

It has given wide powers to supervise and control the banking structure. It occupies the pivotal position in the monetary and banking structure of the country. In many countries central bank is known by different names.

For example, Federal Reserve Bank of U.S.A, Bank of England in U.K. and Reserve Bank of India in India. Central bank is known as a banker's bank. They have the authority to formulate and implement monetary and credit policies. It is owned by the government of a country and has the monopoly power of issuing notes.

2. Commercial Banks: Commercial bank is an institution that accepts deposit, makes business loans and offer related services to various like accepting deposits and lending loans and advances to general customers and business man.

These institutions run to make profit. They cater to the financial requirements of industries and various sectors like agriculture, rural development, etc. it is a profit making institution owned by government or private of both..

Commercial bank includes public sector, private sector, foreign banks and regional rural banks: 3. Public Sector Banks: Currently there are 21 Nationalised banks in India. The public sector accounts for 75 percent of total banking business in India and State Bank of India is the largest commercial bank in terms of volume of all commercial banks.

Now from April 1, 2017 all the 5 associate banks of SBI and Bhartiya Mahila Bank are merged with State Bank of India. After this merger now SBI is counted among the top 50 largest banks of the world.

Nationalized Banks in India

1. Allahabad Bank

2.Andhra Bank

3. Bank of Baroda

4. Bank of India

5.Bank of Maharashtra

6. Canara Bank

7. Central Bank of India

8. Corporation Bank

9. Dena Bank

10. Indian Bank

11. Indian Overseas Bank

12. Oriental Bank of Commerce

13. Punjab & Sind Bank

14. Punjab National Bank

15. Syndicate Bank

16. UCO Bank

17. Union Bank of India

18. United Bank of India

19. Vijaya Bank

4. Private Sector Banks: The private-sector banks in India represent part of the Indian banking sector that is made up of both private and public sector banks. The "private-sector banks" are banks where greater parts of stake or equity are held by the private shareholders and not by government.

5. Foreign Banks: A foreign bank with the obligation of following the regulations of both its home and its host countries. Loan limits for these banks are based on the capital of the parent bank, thus allowing foreign banks to provide more loans than other subsidiary banks.

Foreign banks are those banks, which have their head offices abroad. CITI bank, HSBC, Standard Chartered etc. are the examples of foreign bank in India. Currently India has 36 foreign banks.

6. Regional Rural Bank (RRB): The government of India set up Regional Rural Banks (RRBS) on October 2, 1975. The banks provide credit to the weaker sections of the rural areas, particularly the small and marginal farmers, agricultural labourers, and small entrepreneurs. There are 82 RRBs in the country. NABARD holds the apex position in the agricultural and rural development. List of some RRBs is given below:

7. Co-operative Bank: Co-operative bank was set up by passing a co-operative act in 1904. They are organised and managed on the principal of co-operation and mutual help. The main objective of co-operative bank is to provide rural credit.

The cooperative banks in India play an important role even today in rural co-operative financing. The enactment of Co-operative Credit Societies Act, 1904, however, gave the real impetus to the movement. The Cooperative Credit Societies Act, 1904 was amended in 1912, with a view to broad basing it to enable organisation of non-credit societies.

Three tier structures exist in the cooperative banking:

i) State cooperative bank at the apex level.

ii) Central cooperative banks at the district level.

iii) Primary cooperative banks and the base or local level.

Scheduled and Non-Scheduled Banks: The scheduled banks are those which are enshrined in the second schedule of the RBI Act, 1934. These banks have a paid-up capital and reserves of an aggregate value of not less than Rs. 5 lakhs, they have to satisfy the RBI that their affairs are carried out in the interest of their depositors.

All commercial banks (Indian and foreign), regional rural banks, and state cooperative banks are scheduled banks. Non- scheduled banks are those which are not included in the second schedule of the RBI Act, 1934. At present these are only three such banks in the country.

UNIT-4: Central Banking

RESERVE BANK OF INDIA

Introduction

The Reserve Bank of India (RBI) is India's Central banking institution, which controls the monetary policy of the Indian rupee. The Reserve Bank of India was established on April 1, 1935, in accordance with the provisions of the Reserve Bank of India Act, 1934. Though originally privately owned, since nationalization in 1949, the Reserve Bank is fully owned by the Government of India.

(A) Functions of Reserve Bank of India in Indian Banking System

i) Monetary Authority: It controls the supply of money in the economy to stabilize exchange rate, maintain healthy balance of payment, attain financial stability, control inflation, strengthen banking system of the country.

(ii) The Issuer of currency: The objective is to maintain the currency and credit system of the country to maintain the reserves. It has the sole authority in India to issue currency. It also takes action to control the circulation of fake currency.

(iii) The Issuer of Banking Licenses: As per Section 22 of Banking Regulation Act, every bank has to obtain a Banking license from RBI to conduct banking business in India.

(iv) Banker's to the Government: It acts as banker both to the central and the state governments. It provides short-term credit. It manages all new issues of government loans, servicing the government debt outstanding and nurturing the market for government's securities. It advises the government on banking and financial subjects

(v) Banker's Bank: RBI is the bank of all banks in India as it provides the loan to banks/bankers, accept the deposit of banks, and rediscount the bills of banks. (vi) Lender of last resort: The banks can borrow from the RBI by keeping eligible securities as collateral at the time of need or crisis.

(vii) Banker and Debt manager of government: RBI keeps deposits of Governments free of interest, receives and makes payment, carry exchange remittances, and help to float new loans and manage public debt, act as an advisor to Government.

(viii) Money supply and Controller of Credit: To control demand and supply of money in Economy by Open Market Operations, Credit Ceiling, etc. RBI has to meet the credit requirements of the rest of the banking system. It needs to maintain price stability and a high rate of economic growth.

(ix) Act as clearinghouse: For settlement of banking transactions, RBI manages 14 clearing houses. It facilitates the exchange of instruments and processing of payment instructions.

(x) Manager of foreign exchange: It acts as a custodian of Foreign Exchange. It administers and enforces the provision of Foreign Exchange Management Act (FEMA). 1999. RBI buys and sells foreign currency to maintain the exchange rate of Indian rupee v/s foreign currencies.

(xi) Regulator of Economy: It controls the money supply in the system, monitors different key indicators like GDP, Inflation, etc.

(xii) Managing Government securities: RBI administers investments in institutions when they invest specified minimum proportions of their total assets/liabilities in government securities.

(xiii) Regulator and Supervisor of Payment and Settlement systems: The Payment and Settlement systems Act of 2007 (PSS Act) gives RBI oversight authority for the payment and settlement systems in the country. RBI focuses on the development and functioning of safe, secure and efficient payment and settlement mechanisms.

(xiv) Developmental Role: This role includes the development of the quality of banking system in India and ensuring that credit is available to the productive sectors of the economy. It provides a wide range of promotional functions to support national objectives. It also includes establishing institutions designed to build the country's financial infrastructure. It also helps in expanding access to affordable financial services and promoting financial education and literacy.

(xv) Publisher of Monetary data and other data: RBI maintains and provides all essential banking and other economic data, formulating and critically evaluating the economic policies in India. RBI collects, collates and publishes data regularly.

(xvi) Exchange manager and controller: RBI represents India as a member of the International Monetary Fund [IMF]. Most commercial banks are authorized dealers of RBI.

(xvii) Banking Ombudsman Scheme: RBI introduced the Banking Ombudsman Scheme in 1995. Under this scheme, the complainants can file their complaints in any form, including online and can also appeal to the RBI against the awards and the other decisions of the Banking Ombudsman.

(xviii) Banking Codes and Standards Board of India: To measure the performance of banks against Codes and standards based on established global practices, the RBI set up the Banking Codes and Standards Board of India (BCSBI). (xix) Fair Practices Codes For Lenders:- RBI formulated the Fair Practices Code for Lenders which was communicated to banks to safeguard the rightful interest of the Borrowers.

(B) Promotional Role of RBI

(i) Promotion of commercial banking

(ii) Promotion of cooperative banking

(iii) Promotion of industrial finance

(iv) Promotion of export finance

(v) Promotion of credit to weaker sections

(vi) Promotion of credit guarantees

(vil) Promotion of differential rate of interest scheme

(viii) Promotion of credit to priority sections including rural & agricultural sector

(C) Supervisory Functions of Reserve Bank of India

(i) Granting license to banks & controlling the opening of new branches.

(ii) Bank Inspection.

(iii) Control over Non-Bank Financial Institutions: The Non- Bank Financial Institutions are not influenced by the working of a monitory policy. RBI has a right to issue directives to the NBFIs from time to time regarding their functioning.

(iv) Implementation of the Deposit Insurance Scheme: In order deposits of small depositors, RBI work to implement the Deposit Insurance Scheme in case of a bank failure.

(D) Prohibitory Functions of Reserve Bank of India

(i) It cannot provide any direct financial assistance to any industry, trade or business

(ii) It cannot purchase its own share

(Ii). It cannot purchase shares of any commercial and industrial undertaking

(iv) It cannot purchase any immovable property

(v) It cannot give loans on the security of shares and property

Reserve Bank of India - Terms related to Monetary Policy

Monetary policy refers to the use of certain regulatory tools under the control of the RBI in order to regulate the availability, cost and use of money and credit.

Cash Reserve Ratio (CRR): Banks are required to hold a certain proportion of their deposits in the form of cash with RBI. RBI uses CRR either to drain excess liquidity from the economy or to release additional funds needed for the growth of the economy.

Statutory Liquidity Ratio (SLR): SLR is the amount that commercial banks are required to maintain in the form of gold or government approved securities before providing credit to the customers.

Repo Rate: The rate at which the RBI is willing to lend to commercial banks is called Repo Rate. Whenever banks have any shortage of funds they can borrow from the RBI, against securities. If the RBI increases the Repo Rate, it makes borrowing expensive for banks and vice versa. As a tool to control inflation, RBI increases the Repo Rate, making it more expensive for the banks to borrow from the RBI with a view to restricting the availability of money, Similarly, the RBI will do the exact opposite in a deflationary environment.

Reverse Repo Rate: The rate at which the RBI is willing to borrow from the commercial banks is called reverse repo rate. If the RBI increases the reverse repo rate, it means that the RBI is willing to offer lucrative interest rate to banks to park their money with the RBI. This results in a decrease in the amount of money available for banks customers as banks prefer to park their money with the RBI as it involves higher safety. This naturally leads to a higher rate of interest which the banks will demand from their customers for lending money to them.

The Repo Rate and the Reverse Repo Rate are important tools with which the RBI can control the availability and the supply of money in the economy.

Central Bank vs Commercial Bank

Commercial banks and central bank are important parts of the country's overall economy. While commercial banks offer products and services to businesses and individuals, the country's central bank will offer products and services to the government and other commercial banks. There are a number of differences between commercia! banks and central bank in terms of the services and products offered the customers they cater to, their responsibilities, etc.

Commercial Bank

Commercial banks are the banks that serve customers directly. Commercial banks offer a wide range of banking products and services to individuals and businesses, and the services offered are generally well catered to the specific customer segments with which commercial banks deal. Commercial banks offer a range of deposit products to individuals and businesses such as checking accounts, savings accounts, certificates of deposit, etc. One of the major functions of commercial banks is lending, Lending products include commercial loans, trade finance, mortgage and housing loans, vehicle loans, personal loans, etc. Commercial banks also offer a number of services to their customers such as safe deposit facilities, letters of credit, provision of foreign exchange, etc.

Central Bank

Central banks do not deal with customers directly. Instead, the central bank is known as the banker's bank and controls the entire banking industry. The country's central bank maintains deposits for the government. Government deposits funds for the purpose of providing medical insurance, social welfare, unemployment benefits, etc. Central banks offer short term loans to the country's commercial banks. These loans are provided for banks for their overnight funding purposes and are provided at lower interest rates than the federal funds rate. Central banks offer a number of services to the federal government and other commercial banks such as clearing of funds between member banks, issuing of government bonds, payment of various social security and Medicare programs, etc.

Central banks also play an important role in regulating the country's monetary policy. The central bank increases or decreases interest rates, increases or decreases reserve requirements, etc. The central bank formulates banking rules and regulations and is also responsible to oversee that banking regulations put in place are being followed by conducting regulatory tests.

What is the difference between Central Bank and Commercial Bank?

Commercial banks offer banking products and services to individuals and businesses. Central banks offer products and services to the country's government and other commercial banks. While there are a number of commercial banks in a country with many branches, there is only one central bank that oversees the entire banking operation. Central banks have the power to print money and control the country's monitory policy. Commercial banks and the government hold accounts at the central bank as the central bank is the banker's bank and the government's banks. The central bank regulates the entire banking system and balances funds between commercial banks. While commercial banks offer lending services to individuals and businesses, central banks offer loans to the commercial banks.

Central Bank vs Commercial Banks

(i) The central bank is the apex monetary institution, which has been specially. empowered to exercise control over the banking system of the country. The commercial bank, on the contrary, is a constituent unit of the banking system.

(ii) The central bank does not operate with a profit motive. The primary aim of the central bank is to achieve the objectives of the economic policy of the government and maximize the public welfare through monetary measures. The commercial banks, on the other hand, have profit earning as their primary objective.

(iii) The central bank is generally a state-owned institution, while the commercial banks are normally privately owned institutions.

(iv) The central bank does not deal directly with the Public. The commercial banks, on the contrary, directly deal with the public.

(v) The central bank does not compete with the commercial banks. Rather it helps them by acting as the lender of the last resort.

(vi) The central bank has the monopoly of note-issue, whereas the commercial do not enjoy such right.

(vii) The central bank is the custodian of the foreign exchange reserves of the country. The commercial banks are only the dealers in foreign exchange.

(viii) The central bank acts as the banker to the government, the commercial banks act as bankers to the general public..

(ix) The central bank acts as the bankers' bank: (a) The commercial banks are required to keep a certain proportion of their reserves with central bank; (b) the central bank helps them at the time of emergency; and (c) the central bank acts as the clearing house for the commercial banks. But, the Commercial banks perform no such function.

ROLE OF CENTRAL BANK IN DEVELOPING ECONOMY

The central bank is regarded as the supreme monetary authority in every country, and accordingly it has to perform various useful functions for ensuring smooth functioning of the economy. Besides the discharge of certain traditional functions the central bank in a developing economy can play a special role, as is true of the Reserve Bank.

This role can be understood from the following functions performed by the RBI:

(i)Expanding currency supply for financing development plans: A developing country like India is to undertake massive development plans and programmes for accelerating the pace of development. The government requires a vast amount of finance for this purpose, for which the country is to rely on the method of deficit financing (e. the issue of new paper-notes) in addition to using other methods.

The banking sector is to provide adequate finance for this purpose. The central bank, being the sole note-issuing authority can assist the government by expanding the supply of currency to enable the government to finance its massive plan outlays.

Actually the Reserve Bank of India has been assisting the Government of India by expanding the supply of currency. But, the supply of currency (and credit) is to be properly regulated for enabling the economy achieve faster growth with reasonable price stability.

(ii) Resource mobilisation and supply of adequate credit : The mobilisation of resources for development purposes is an essntial requirement in a developing economy. In such an economy, the central bank can assist the government in mobilising domestic resources for financing the development plans through such activities as the floating of new loans of the government, strengthening the banking structure for mobiiising resources even from the rural areas, and so on. Apart from these the central banks to make necessary arrangements for the supply of adequate bank credit which is so essential for developmental activities.

(iii) Increasing the flow of bank credit to the priority sectors: The formulation of development priorities is an essential characteristic of development planning. The central bank of a developing country is to frame its monetary and credit policy in such a fashion that larger and desired quantities of bank credit go to the priority sectors, such as agriculture, cooperatives, small industries and export trade.

Furthermore, for social and economic along with economic growth achieving, it has to formulate a policy for extending liberal bank credit to the weaker and hitherto neglected sections of the community,

At the same time it can follow the policy of credit restraint for maintaining price stability and for ensuring proper use of bank credit. For this reason the Reserve Bank of India has been following a monetary and credit policy what is known as the policy of controlled expansion of bank credit. Through it the R.B.I, can undertake the direct financing of development projects by lending liberally to those institutions which provide development finance.

(iv) Controlling Inflation and containing cost escalation: The rising price level is regarded as a concomitant of economic development. The central bank in a developing economy is required to take necessary steps in holding the price line at a desired level so that plan-estimates are not totally upset due to cost-escalation.

In a developing economy various traditional and new measures of monetary controls, especially selective credit controls, are used to check the inflationary rise in prices. The measures like higher margin requirements for speculative bank advances, higher CRR and incremental CRR, higher statutory liquidity ratios, penal rates of interest on excessive borrowings differential interest rate policy, higher bank rates and lending rates, etc. may be adopted by the central bank, as done by the Reserve Bank of India, for controlling inflation and for containing, or at least moderating, cost escalations of development projects.

(v) Creation of a strong Infrastructure and expansion of institutional facilities for agricultural and industrial finance : For creating a strong and integrated infra structure a developing economy is to extend institutional facilities for agriculture and industry, as such facilities are grossly inadequate. The central bank in such a country can take some positive steps for extending the institutional facilities for agricultural and industrial finance.

Thus, the Reserve Bank of India has taken active steps in reorganising the rural credit structure through co-operatives, the National Bank for Agriculture and Rural Development (NABARD), regional rural banks, lead banks.

Similarly, in developing institutional facilities for industrial finance it played a very significant role by establishing some specialised institutions like the Industrial Finance Corporation, the Industrial Development Bank, etc. The central bank in a developing economy usually sponsors the establishment of policy of controlled expansion of bank credit as followed by the Reserve Bank of India for promoting economic growth with stability. Through this monetary policy the central bank can bring about a desired allocation of resources especially capital.

This task is a very delicate one as it has to strike a balance between two apparently conflicting objectives:

(a) Expansion of the economy, and

(b) Control of such expansion for achieving price stability.

(viii) Developing sound banking structure: The central bank in a developing economy can also take various positive steps and adopt various measures such as deposit insurance, nationalisation of banks, creation of a suitable bill market scheme and so on for building a sound banking structure, or financial infrastructure which is essential for achieving faster economic growth.

(ix) Advising government on plan matters: The central bank in a developing economy like India, can also advise the government not only on banking and financial matters but also on a wide range of economic issues related to national economic planning and resource mobilisation. Besides, a central bank should keep a strict watch over any possible sign of misdirection of the economy and accordingly it should give timely and proper advice to the government.

(x) Economic surveys and collecting basic statistics : Finally, the central bank in a developing economy like the R.B.I, often conduct surveys on various uncovered sectors and supply valuable data on national economic plans and policies to the government for formulating development plans.

Conclusion: Thus, the central bank has to play a special role in developing countries, viz., for promotion (expansion) of growth with stability. In most developing countries, at least at the early stage of development, there is unlikely to exist a sound commercial banking system which can make adequate provision for the growing need for finance. In such a situation, the central bank should come forward to fill in the credit gap

CREDIT CONTROL

Credit control is the policy of the central bank to expand or contract the credits to achieve predetermined goals.

Objectives of Credit Control: The main objectives of credit control are as follows:

(a) Exchange rate Stability: The first & foremost important objective of credit control is to keep exchange rate stable. Exchange rate stability is of great significance for the maintenance of international confidence & for the smooth conduct of International

(b) Price Stability: Another important objective of credit control is to maintain general price level stable in the economy i.e., to curb inflationary forces. Price stability refers to the prevention of wide fluctuations in the prices. Fluctuations in price level either in upward direction or downward direction distort the entire economic system of the country.

(c) Economic Growth: Another important objective of credit control is to achieve the aim of economic growth. Prof. Meier defined, "Economic growth as the process whereby real per capita income of a country increase over a long period of time."

(d) Stability in Money Market: Money market refers to totality of all financial institutions which deals with short term funds. Some economists stress that credit control should aim at the stabilization of money market. For this it should offset seasonal variations in demand for funds & provide credit in times of crisis.

(e) Elimination of Fluctuations in Business Cycles: Another important objective of credit control is to eliminate wide fluctuations in trade cycles/Business by using Quantitative & qualitative instruments of credit control.

Methods of Credit Control

Quantitative & Qualitative Credit Controls Measures

Quantitative Controls:

These are controls designed to regulate the overall volume of credit created i.e. loans given by banks. The principal instruments used under these controls are as follows:

Bank Rate:

- It is that rate of interest at which the RBI provides refinancing facilities to commercial banks by rediscounting their bills of exchange or other commercial papers.
- In other words, Bank Rate is the rate at which the RBI extends credit to commercial banks. The Bank Rate at present is 9 percent.

Cash Reserve Ratio:

- The RBI Act, 1934 stipulates that a commercial bank is required to keep a certain percentage of its total deposits with the RBI in cash.
- The RBI can vary this percentage. As such, this is also called Variable Reserve Ratio. This ratio at present is 4 percent. Quantitative & Qualitative Credit Controls Measures
- Generally, the RBI permits Banks to maintain minimum daily average holding of 70 percent of the mandated 4 percent CRR.
- However, it tightened this requirement w.e.f. July, 2013 by raising the minimum daily average holding from 70 percent to 95 percent. This measure aims at squeezing liquidity from the system.

Statutory Liquidity Ratio:

- It is that ratio/percentage of its total deposits which a commercial bank has to maintain with itself at any given point of time in the form of liquid assetslike cash in hand, current balances with other banks and first class securities (generally government securities).
- This ratio at present is 22 percent. The Banking Regulation Act, 1949 has been amended to empower the RBI to lower it as and when it deems necessary.

Open Market Operations:

- These are operations which involve the sale and purchase of government securities by the RBI vis-a-vis the banking system. Quantitative & Qualitative Credit Controls Measures
- These operations not only help in stabilising the prices of government securities but more importantly, controlling the inflationary pressures from time to time as well as increasing/decreasing the supply of money.
- The RBI uses this tool on a regular basis to adjust liquidity.

Qualitative or Selective Credit Controls:

- They are controls designed to regulate both the volume of loan and the purpose for which loans are given by commercial banks.
- The techniques of Selective Credit Controls are minimum margins for lending against specific securities, ceiling on the amount of credit for specific purposes (called rationing of credit) and discriminatory rates of interest charged on certain types of advances.
- Through selective credit controls, the RBI tries to maintain sectoral and regional balance. Selective controls also include exercising its moral suasion by the RBI over banks and, as a last resort, taking direct action by way of punitive measures.

Expansionary Monetary Policy

An expansionary monetary policy (cheap or ease) is used to overcome a recession or a depression or a deflationary gap. This policy requires a decrease in interest rate or increase in money supply. It helps in following ways.

(a) Consumption: Since people make most big purchases (homes, cars, washing machines etc.) on finance, a lower interest rate would encourage spending & consumption.

(b) Savings: A lower interest rate could also make savings look less attractive. This will encourage consumer consumption.

(c) Investment: Investment will increase as firms will find it more profitable to invest or borrow money. It will become cheaper for business to borrow money & invest.

(d) Exchange rate: A lower interest rate could lead to a depreciation in the exchange rate, making exports more attractive than imports.

FISCAL POLICY EFFECTS ON INVESTMENT & AGGREGATE DEMAND

Fiscal policy refers to the budgetary policy of govt. or the policy related to revenue, expenditure & debt of the government with a view to correcting the situations of Excess demand or deficient demand in the economy.

Fiscal Policy actions are generally classified under the following categories.

(A) Discretionary Fiscal Policy

A discretionary fiscal policy is one in which adhoc changes are made in the govt. spending & taxation system & tax rates at the discretion of the govt. as & when required. In discretionary fiscal policy, the govt, makes deliberate changes in:

(a) The level & pattern of taxation: The discretionary changes in taxation include such changes in both direct & indirect taxes

(i) increasing the taxes during inflationary phase & decreasing the taxes during deflationary or recessionary phase.

(ii) Imposition of new taxes during inflationary phase in order to reduce excess demand & abolition of taxes during deflationary phases in order to increase deficient Demand.

All these kinds of changes in taxation result in either the flow of household incomes to the Government or to reduction in such flows. Tax changes that reduce disposable income of the households cause a decline in the consumer demand & therefore a contractionary effect on the economy. This process helpful in reducing inflationary pressure in the economy,

Discretionary Changes in Govt. Expenditure: The discretionary changes in the govt. spending include in (i) Size of the govt. expenditure (ii) The pattern of government expenditure (iii) The methods of financing govt. expenditure (iv) Transfer payments (e.g-subsidies, old age pensions, unemployment relief etc. (v) Overall budgetary deficit (vi) Method of deficit financing.

(B) Compensatory Fiscal Policy

Another variant of stabilising policy is compensatory fiscal policy. The compensatory fiscal policy is a deliberate budgetary action taken by the govt. to compensate the deficiency in & to reduce the excess of aggregate demand. The compensatory action is taken by the govt. in the form of surplus budgeting or deficit budgetingn

The Policy of Surplus budgeting is adopted when the govt. is required to control inflation & policy of deficit budgeting is adopting when the objective is to control deflation. During the period of depression, the govt. is required to boost up the aggregate demand, especially when the economy is facing depression due to lack of effective demand. The govt. is required to take compensatory fiscal measures. The compensatory fiscal measures may be in the form of tax reduction & enhanced govt. spending. This kind of fiscal measures increases Aggregate Demand (AD).

During the high inflationary phase, Policy of surplus budgeting is adopted by the govt. to control excess Aggregate demand (AD).

(C) Automatic Stabilization Policy

The automatic fiscal policy means adopting a fiscal system with built in flexibility of tax revenue & govt. spending. Built-in-flexibility means automatic adjustment in the govt. expenditure & tax revenue in response to rise & fall in GDP. In this kind of fiscal policy, Govt. adopts a tax system & an expenditure programme linked to GDP & unemployment. As a result, tax revenue increase & govt. expenditure decreases automatically with an increase in GDP. Tax revenue increases because household income increases with increase in GDP. Likewise, tax revenue decreases & govt. expenditure increases automatically, with decrease in GDP & increase in unemployment.

UNIT-5: Monetary and Fiscal Policies

Monetary Policy

Monetary policy is that by which the govt. of a country and central bank try to control the supply of money and the availability of credit and the cost of credit in the economy, with a view to achieving Economic Stability.

Standard Definition of Monetary Policy "Monetary Policy is essentially a programme of action undertaken by monetary authorities, generally the Central Bank, to control and regulate the supply of money with the public and the flow of credit with a view to achieving certain pre-determined economic goals."

According to D.C. Aston, "Monetary Policy involves the influences on the level and composition of aggregate demand by the manipulation of interest rates and availability of credit."

Objectives of Monetary Policy

Monetary Policy, in essence, is the economic policy of the government in the monetary field. Thus, the objective of monetary policy must be regarded as being part of the overall economic objectives to be pursued by the govt. The Primary objective of monetary policy is basically supposed to help accelerate economic development. Monetary policy being a part of public policy is designed and directed to achieve different macro economic goals, depending on the basic problems and the nature of the economy of the country from time to time. In developed country, the monetary policy has to serve the function of stabilization and maintaining proper equilibrium in the economic system & in developing economies, Monetary Policy has been playing dynamic role in overall economic growth & development.

The Main objectives of Monetary Policy are as under:

(a) Neutrality of Money: Professors wichsteed, Hayek and Robertson held that the best monetary system is one in which money is neutral. In their opinion, the Monetary authority should aim at the complete neutrality of money. Money should be a passive factor. It should not be allowed to interfere with economic forces like productive efficiency, real cost of production and consumer preferences. The policy of neutral money seeks to do away the disturbing effects of changes in the quantity of money on different economic entities such as prices output, employment and income.

(b) Exchange rate Stability and Equilibrium in Balance of Payments : Maintenance of Stable Exchange rates is an essential condition for the creation of international confidence and promotion of smooth international trade on the largest scale possible,

Exchange rate refers to the rate at which one unit of currency of a country can be exchanged from the number of units of currency of another country.

1$=₹69

Instability in exchange rate might lead to undesirable effects such as weakening of the value of currency in the world market, speculation and even flight of capital abroad. Thus, fluctuations in exchange rate very much influence the Balance of Payments. It is monetary policy that brings stability in Exchange rate.

(c) Stabilization of Domestic Prices and Control of Business Cycles: Another important aim of monetary policy is to achieve and maintain price stabilisation and normal course of business activity through appropriate credit regulation measures adopted by the Central Bank.

Price stability does not mean price rigidity. It actually means relative price stability. It means controlling inflation or deflation. When the price stability is maintained, economic fluctuations and trade cycles are checked.

Monetary policy has to serve as anti-cyclical policy to achieve economic stabilisation. During inflationary situation, a restrictive monetary policy is useful. During depression, an expansionary monetary policy is called for.

(d) Credit Control: Monetary Policy also aims at to control credit. Credit directly influences the pattern of investment and production in the economy. In order to control credit, the monetary authority or Central Bank of a country used the Quantitative and Qualitative tools.

(e) Economic Growth: Another important objective of economic policy is to achieve high Economic Growth Prof. Meier defined, "Economic Growth as the process whereby the real per Capita Income of a country increases over a long period of time." It means increase in national output. Monetary policy promotes sustained and continuous Economic Growth. Thus, Monetary Policy follows an easy monetary policy to suits the requirements of Economic Growth.

(f) Full Employment: Full employment implies a situation where in all competent persons who are willing to work at the prevailing wage rate, get work. During Boom phase, there is rapid increase in demand and thereby the production is also increased in order to meet the rising demand if also leads to full employment of all factors of production. During the period of depression, there is low production, because of low demand and wide scale of unemployment. Hence, the objective of monetary policy is to check rising unemployment during depression.

(g) Creation and Expansion of Financial Institutions: With a view to speed up the pace of economic growth there by economic development, creation & expansion of financial institutions is pre requisite condition. Monetary policy helps in expanding the financial institutions by opening new branches of commercial banks, cooperative Banks, Therefore, monetary policy works in this regard too.

(h) Debt Management: Debt. Management is another objective of Monetary Policy. It is central bank of a country which undertakes the selling and government bonds & securities and making timely changes in the structure and composition of public debt.

Role of Monetary Policy in Development Economies or Countries

Monetary Policy plays a significant role in accelerating pace of economic growth and economic development in developing and underdeveloped countries. According to Meier and Baldwin, "Monetary Policy also plays some part in accelerating development by influencing the supply and uses of credit combating inflation and maintaining Balance of payments."

Monetary policy has to play a vital role in developing the economy from a stage primary backwardness to a stage of self-sustained growth. Under the growth-oriented monetary policy, monetary management by the cental bank becomes a strategic factor of development in developing economies.

The role of monetary policy in Developing Countries can be discussed as under:

(a) Monetary Policy and Mobilization of Savings: Monetary Policy helps in the mobilization of savings in developing economies by establishing banks and financial institutions in far-off places, rural areas and backward places with a view to achieve the target of Financial Inclusion. Financial Inclusion of all helps in mobilisation of savings for different economic activities. In this regard, Monetary Policy is working as:

(i) Establishment of Financial Institutions

(ii) Attractive Savings Schemes

(iii) Insurance Schemes

(b) Monetary Policy & Capital Formation or Investment: Monetary Policy can go a long way to promote capital formation by stimulating savings and investment in the economy. Monetary policy can make a considerable help in increasing rate of capital formation. For promoting high rate of investment, monetary policy has to work on following fronts:

(i) Promoting Private Investment.

(ii) Creating a strong, vibrant and efficient financial institutional structure for mobilization of savings.

(iii) Making arrangement for Government Investment.

(c) Monetary Policy and Price Stability: The Monetary Policy has to promote economic development without ceating inflationary conditions in a backward and developing economies. The monetary policy in these countries will have to work for two divergent objectives of credit expansion and credit control. Thus, the Central Bank through its monetary policy can ensure price stability through its traditional and non traditional methods of credit control. In India, RBI's monetary policy in inflation-targeting i.e., to stabilize price level.

(d) Monetary Policy and Balance of Payments: Another important role played by monetary policy is to correct the disequilibrium balance of payments. These developing economies generally find themselves in balance of payments difficulties due to excess of developmental imports over their meager exports. Monetary policy can help in slipping balance of Payments problem by making exchange rate stable. The central bank utilises direct methods of exchange control and traditional methods of exchange control like bank rate Policy, CRR, SLR, Repo rate, Reverse Repo rate. etc. to solve BOP Problem in developing countries.

(e) Monetary Policy and Maximization of output & Employment: According to layres, the objective of monetary policy should be to ensure the maximum utilization of productive resources in the economy. Monetary policy should be used in such a way as to promote full employment of resources in the economy. In order to create employment opportunities, the proper policy is to promote investment which may be done by

(i) The creation of additional money.

(ii) The creation of additional bank deposits.

(iii) Greater velocity of circulation of money through activating of Idle cash balances.

(f) Monetary Policy and Economic Development: Monetary Policy has been advised by many economists as an effective tool of economic growth and economic development in a developing economies. Expansionary or Ease Monetary Policy or cheap Monetary Policy helps in promoting economic growth. Restrictive or Expensive Monetary Policy helps in reducing economic growth and thereby economic development Monetary Policy is working for achieving higher economic growth trajectory and thereby making it sustainable in developing countries.

(e) Monetary Policy & Debt. Management: Another important function performed by Monetary Policy in developing economies is Management of Debt. when the govt. total expenditure exceeds total Revenue Receipts, Govt. usually resort to borrowing. from both the internal and External sources. Govt. takes debt from general public by issuing Govt. securities, such as bonds, treasury bills. Govt. also borrows from its employees in the form GP.F., N.P.S., P.P.F etc. and used these funds for meeting exceeding expenditure.

FISCAL POLICY

Fiscal Policy refers to budgetary policy of the govt. or the policy related to revenue and expenditure of the Government with a view to correcting the situations of Excess or deficient Demand in the Economy.

The word 'Fisc' means 'State treasury'. Thus 'fiscal policy' refers to policy concerning the use of state treasury.

Definitions of fiscal Policy

According to Prof. Dalton, "Fiscal Policy is the policy concerning the revenue expenditure and debt of the govt. for achieving the definite objectives."

According to Paul Samuelson, "Fiscal Policy means public expenditure and tax policy."

Objectives/Features of Fiscal Policy in the Developing Economics:

The main objective of fiscal policy in developing economies are discussed as below:

(i) Maximise the level of aggregate of aggregate savings: The first and foremost important objective of fiscal policy in developing economies is to maximise the level of aggregate savings by applying a cut to the actual and potential consumption at large. In order to promote savings, the rate of income tax is enhanced and then tax incentives are provided for savings.

(ii) Maximising the Rate of capital formation: In developing & underdeveloped economies. Fiscal policy also aims at the maximization of Rate of Capital formation or Investment in order to breakdown economic stagnation and thus lead the country to the path of rapid economic progress. Government in its budgetary policy makes certain changes in income tax, corporation taxes and gives many tax incentives to firms with view to increase the level of investment in the economy. Increased level of investment facilitates the pace of Economic growth.

(iii) Divert Capital Resources: The third objective of fiscal policy in the context of developing and UDCs is to divert capital Resources from less productive to more productive and from socially less desirable to socially more desirable uses. This objective is implicated in planned economic development.

(iv) Increase Employment Opportunities : Another important objective of fiscal policy is to increase employment opportunities. In order to create employment opportunities, Govt. undertakes various social public work programmes such as construction of roads, dams, bridges etc. involving more labour or less capital per head.. In rural areas, efforts should be made to encourage domestic industries by providing training, finance, marketing facilities and small machines connected with them. Thus, it helps in generating more and more employment opportunities.

(v) Curb Inflationary Forces: Fiscal policy also aims at to the protect the economy from the demon of inflationary forces. Fiscal policy used its instruments to curb inflationary forces. These are increase in taxes, Decrease Govt. Expenditure, Reduce Deficit financing and Increasing Public Borrowing. Fiscal Policy should be designed in such a manner as to curb inflationary forces arising during the process of economic growth.

(vi) Eliminate Sectoral Imbalances : Another important objective of fiscal policy in developing countries is to eliminate sectoral imbalances in the economies. Fiscal Policy focuses on those sectors which are weak and backward in terms of economic growth and economic development. It can be done by budgetary allocations to these backward areas for their upliftment.

(vii) Economic Stability: Another objective of fiscal policy in a developing economy is the promotion and maintenance of Economic Stability. It can be done by eliminating the inflationary and deflationary forces.

(vii) Eliminate the Glaring Inequalities of Income & Wealth: One of almaring problem of developing and under developed economies is to eliminate the glaring inequalities in income and wealth. These economic inequalities create social cleavages, which leads to economic and political instability and stand in the way of economic development. The Economic Growth of a country meaningless if its fruits are not enjoyed by the lowest section of the society. Thus fiscal policy aims at the redistribution of income and wealth.

(ix) Fiscal Policy aims at Increasing National Income as well as per Capita Income : Fiscal Policy aims at Increasing National income as well as per capita Income. If can be done through effective tax system, effective increase in demand and suitable economic policy.

Role of Fiscal Policy in the developing Economies

Fiscal Policy is a powerful instrument of stablisation. Fiscal policy refers to government actions affecting its receipts and expenditure which we ordinarily take as measured by the govt.'s net receipts, its surplus or Deficit Government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment. Though the ultimate aim of fiscal policy is the long-run stabilization of the economy, yet it can be only achieved by moderating short-run economic fluctuations.

Fiscal Policy role in the context of developing and under developing countries in discussed as under :

(a) Taxation and Economic Development : Taxation or Revenue Receipts is the principal fiscal policy instrument. According to Dr. Baljit Singh, "Consumption taxes becomes more important as they really activate the Economic System". It implies that taxes fulfill the major aim of fiscal policy i.e., to curb consumption and to encourage savings and investment. But it does not mean consumption should be severely curbed. Taxation as a fiscal instrument used only to reducing glaring income & wealth inequalities gaps between rich and the poor. Tax policy aims at economic equality includes the following measures.

(i) Taxation of personal and corporate incomes at progressive rates.

(ii) Impositions of property and wealth tax.

(iii) Taxation of high prices and luxury goods at higher rates.

(b) Public Expenditure and Economic Development: Another important instrument of fiscal policy is Public Expenditure. Public Expenditure has favourable effects on overall economic growth and development. Public Expenditure is of various types.

(i) Direct investment on projects like irrigation, roads, bridges etc..

(ii) Expenditure on the various types of subsidies to the producers with a view to encouraging production.

(ii) Making provision for financial aid for the unemployed for their self-employment.

Govt. can stimulate investment through the provision of overhead facilities like means of transportation, communications, ports, engineering industry, power installations, technical training etc. These are known as economic and social over heads of developing and underdeveloped countries. These investments have widened the market, raising the productivity of labour, reducing costs of production in several sectors of economy in the developing economics.

(c) Public Debt and Economic Development: Another tool of fiscal policy is Public Debt. The taxation capacity of developing and underdeveloped countries is very low due to low per capita income. Thus Revenue Receipts alone is not a sufficient source of capital for Govt. expenditure then Govt. usually resorts to borrowings to finance the capital projects. Borrowing include both internal and external borrowings. Therefore Debt is an important instrument of fiscal policy when Govt. expenditure exceeds Govt. Revenue Receipts. Raising of loans from internal sources is one of the safest and convenient ways of financing the plans. Public debt generally utilizes the idle hoarding of the people.

(d) Deficit financing and Economic Development: Deficit financing refers to issuing or printing of new currency to meet budgetary deficit. Deficit financing is of recent origin & has become powerful tool in developing & UDCS as a source of development finance. In these developing countries, deficit financing is increased during the times of deficient Demand so that the overall level of purchasing power is increased in the economy & consequently economic growth starts working. However, creation of new currency or money increases money supply & leads to rise in prices or inflation.

Conclusion: In Nutshell, we can say that fiscal policy aims at to solve the problems of poverty, unemployment, low standard of living using fiscal or budgetary policy measures. These evils can be removed by setting the cycle of rapid economic growth.