UNIT 1 MONEY: NATURE, FUNCTIONS AND SIGNIFICANCE

Structure

1.0 OBJECTIVES

After reading this unit, you should be able to:

- define money
- identify problems of barter which led to invention and evolution of money
- distinguish between money and near-money
- appreciate the role and importance of money in a capitalist economy
- identify functions of money and its defects.

1.1 INTRODUCTION

We are all familiar with money as we live in a monetary economy where money is used freely and widely in settlement of various economic transactions. We are so much accustomed to money now that it is difficult for us to imagine a modern society without money. It will be interesting to know why and how this money came into being. In this introductory unit, you will study how money came into being, its definition, role, importance, actions and defects.

1.2 PROBLEMS OF BARTER SYSTEM

Before the 'advent of money, the activity of exchange was carried out through barter system. In barter system people exchanged goods and services in their possession with goods and services available with others. For example, a farmer exchanged his surplus foodgrain (over and above his own needs) with the weaver for his surplus cloth. This activity helped both the farmer and weaver to satisfy their wants. The barter system of exchange worked well so long as human wants were simple and limited in number. However, in course of time human wants multiplied, which led to specialisation of occupations. This resulted in a lot of difficulties for exchange through the barter system. Consequently, need for a single and commonly acceptable medium of exchange was fell, This ultimately led to invention and evolution of money.

In the barter system people faced the following major problems:

1) **Lack of double coincidence of wants**: Barter requires double coincidence of wants. For instance, if 'A' has a goat rind wants to exchange it for cloth. Then he

must find some person who has surplus cloth to offer while, at the same time, needs the goat which is offered by 'A'. Such coincidences were easy when human wants were simple and number of goods produced were limited. But, as number of goods multiplied, such coincidences of wants became both difficult and time-consuming. With the advent of money, this difficulty disappeared, as one can now sell product for money and then with the help of that money he/she can buy goods and services of his/her choice.

2) **Problem of a common measurement of value:** In the absence of money, value of every commodity was to be ascertained in terms of all other goods. For example, how much wheat or milk or salt or rice needs to be offered in exchange for one meter of cloth? If there were, say, 10 goods in a society, people were required to determine and remember 45 values, while if there were 100 goods there would be 4950, such values. The number of exchange values required for transactions may be found by the expression,

$\frac{n(n-1)}{2}$ where 'n' is number of goods.

However, with money in circulation, vaiue of each commodity has to be expressed only in terms of money. Hence, in case of 100 goods, in a monetary economy people will have to know only 100 values.

3) **Loss due to sub-division of goods:** Many goods, if sub-divided, will lose their value partially or sometimes wholly. For example, a table or a refrigerator or a TV set cannot be sub-divided into parts as in doing so they will lose their value. In this situation, a person who wants to exchange his TV for five or six commodities, will find it difficult to get all these five or six desired goods from one person. Hence, he would need to sub-divide the TV into five or six parts, but by doing so TV will lose its value. On the other hand, if money is used as a medium of exchange, there would not be any such problem as money is perfectly divisible.

4) **Difficulty in storage sf** wealth: It is veiy difficult to save and create wealth in the absence of money as many of the goods lack durability, and all kinds of services are perishable and hence cannot be stored for future use. People could not think of storing something to provide against future contingencies as wealth stored in the form of goods like wheat, animal skin, etc., would not last long. However, money being durable has become a convenient form to save and store wealth.

1.3 EVOLUTION AND KINDS OF MONEY

As you know, at present money consists of coins, currency notes and deposit money. However, it has taken hundreds of years to acquire its present form. During the early

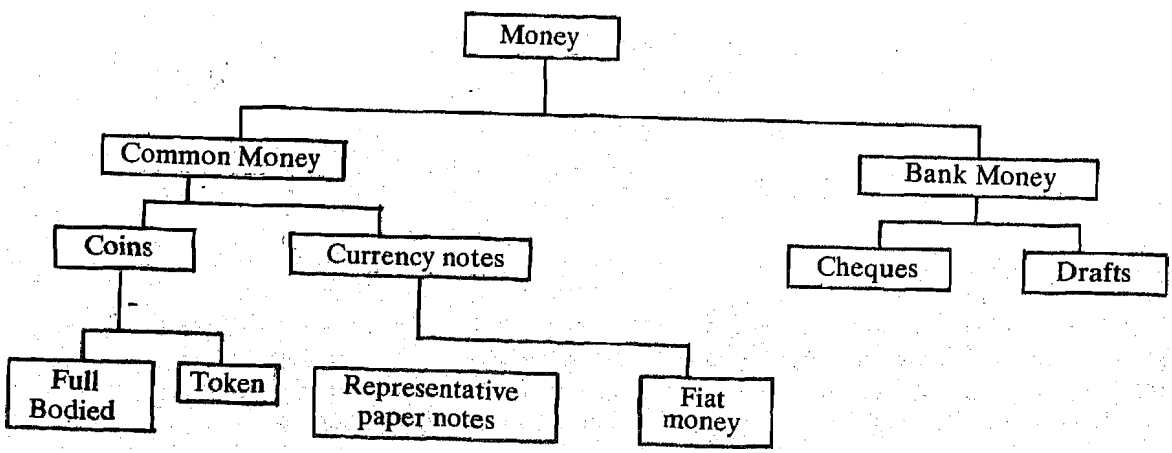

Figure 1.1 Kinds of Money

part of civilisation, money was in the form of commodity money like the cow. sheep, wheat, rice, tobacco, tiger teeth, elephant tusks, etc. The particular commodity chosen as money depended upon various factors like the climate, the level of cultural and economic development of the community, etc. In cold countries like Alaska and Siberia, animal skins and furs were used as money. In tropical countries elephant tusks and tiger jaws were used as money. In agricultural communities domestic animals and goods of daily use took the form of money. However, with the passage of time their use as money was given up due to lack of their durability, absence of a standard form, etc. The present day nroney has also passed through three stages : (i) metallic money, (ii) representative paper money, and (iii) credit money. The present inconvertible paper currency and other credit instruments acting as substitutes for legal money are only a recent development. Figure 1.1 shows the different kinds of money which exist in modern economies.

With progress of civilisation and economic advancement of societies, metallic coins made of gold, silver, copper etc., were used as money. These coins were of two types :

i) Standard coins or full-bodied coins, as they were called, because their face value and intrinsic value were the same ; and ii) token coins, those coins whose face value was much higher than their intrinsic value.

Later on, currency notes were introduced to replace metallic coins primarily for two reasons: *firstly,* to economise the use of precious metals and avoid their wastage ; and ***secondly,*** for the sake of convenience of storage and transportation of paper vis-a-vis the coins. In order to build up the confidence of the public in paper currency, initially the currency notes took the form of representative notes. These rapresentative notes were simply substitutes for metallic money, i.e., convertible into gold or silver coins on demand by the bearer. With increased use of paper money for transactions (due to expansion in production, population and monetized section of the economy) it became almost impossible to allow such convertibility. The present day currency notes are, therefore, no longer convertible into gold or silver coins and as such may be termed as flat money. Nowadays a sizeable portion of common money comprises this non-convertible paper currency.

Credit money is of more recent origin. People keep a part of their cash with banks which they can withdraw at any time they like or can transfer to some other person through a bank cheque. The cheques and drafts, being most convenient form of transferring value, have come to be accepted as bank money, though they are not money proper as their acceptance is optional. However, they perform the most important function of money, viz. as a medium of payment.

1.4 WHAT IS MONEY 3

Different economists have given different definitions of money. Some of the definitions are too narrow while others are too extensive. A few of the important definitions are given below :

A. C. Pigou — "In order for anything to be classed as money, it must be accepted fairly widely as an instrument of exchange."

G.D.H. Cole — "Money is anything that is habitually and widely used as means of payment and is generally acceptable in the settlement of deb."

Walker — "Money is what money does."

J.M. Keynes — By money is to be understood "that by-&livery of which debt-contracts and price-contracts are discharged, and in the shape of which a store of General Purchasing Power is held."

Alfred Marshal — "Money constitutes all those things which are at any time and :place, generally current without doubt or special enquiry as a means of purchasing commodities and services, and of defraying expenses."

D.H. Robertson — "Money is anything which is widely accepted in payment for goods or in discharge of other kinds of business obligations."

Crowther — "Money can be anything that is generally acceptable as a means of exchange and that at the same time acts as a measure and a store of value."

Analysis of the above mentioned definitions will reveal that it is not easy to include all the essentials of money in one sentence. None of the above definitions is, therefore, comprehensive and satisfactory. However, these definitions help us to identify the basic features of money which may be summed up as under:

1) Money may be anything (even a piece of paper) which is chosen by common consent as a medium of exchange or means of transferring purchasing power.

2) It is widely accepted in payment for goods and services and in settlement of all transactions, including future payments.

3) It should be acceptable without reference to the standing of the person who offers it in payment. This is because money contains liquidity, i.e. generalised purchasing power, which can be passed on to others in exchange of goods and services.

4) Money is received customarily by all without any special tests of quality or quantity.

Near-Money

There are certain assets which are highly liquid, though not perfectly liquid like money. These assets can easily be converted into money without much loss of time or value and have, therefore, come to be known as 'Near-Money.'

Examples of near-motley are bills of exchange, bonds, saving certificates, treasury bills, debentures, etc. Such near-money assets are **claims on money** i.e., these assets have to be first converted into actual money before using them for the purchase of any commodity. The importance of near-money asset, therefore, lies in the ease with which it can be sold in the market without much loss of time or value. However, both money and near-money are similar in one respect: that both of them are claims. Money is a claim over the government or central bank of the country, who has issued it while bank money is a claim over banks with whom money is held as public deposits. Like wise near-money is also a claim over it's issuing authority. For instance, a bill of exchange is a claim over the party which has agreed to pay the amount specified in the bill at the expiry of the specified period, say 91 days. Similarly, a bond represents a claim on the government which has issued it.

Check Your Progress A

1) List the essential features of money.

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2) Distinguish between money and near-money.

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3) A barter system of exchange faces the following problems :

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ii) . . . . . .

iii) . . . . . .

iv). . . . . .

4) Which of the following statements are *True* and which are ***False*** ?

i) In a barter system of exchange people exchange goods for goods.

ii) Fiat money is convertible into gold or silver coins on demand by its bearer.

iii) Bank money performs the function of a medium of exchange.

iv) Those assets which are perfectly liquid like money are called near-money.

) Money is something which is widely accepted in payment for goods and services.

1.5 NATURE OF MONEY

Money is only a means and not an end in itself. It is demanded not for its own sake but because it helps us in buying goods and services to salisfy our wants. Money cannot directly satisfy human wants, but assists in production and exchange of goods and service's. Its significance lies in its ability to command goods and services and liquidate business obligations. Money gives mobility Io capital and aids division of labour and specialisation, thereby making large scale production possible. It has been rightly remarked that 'we cannot eat money but we cannot eat without money either.'

1.6 FUNCTIONS OF MONEY

Money is what money does.' According to this statement, the importance of money lies in the functions it performs. Primarily money performs four basic functions which are summed up in the following couplet : *"Money is a matter of functions four: A , medium, a measure, a standard & a store."* However, it has become customary to classify the functions of money under three heads :

1) Primary Functions — Money performs two basic functions. It acts as a :
   i) Medium of exchange
   ii) Measure of value.
2) Secondary Functions — The other important functions of money (derived from the primary functions) are :
   i) Standard of deferred payments
   ii) Store of value
   iii) Transfer of value
3) Contingent Functions — In the modern economy money has certain incidental uses like :
   i) It is the basis of a credit system
   ii) It helps in the distribution of national income
   iii) It helps in maximisation of utility as well as of profits
   iv) It imparts liquidity to wealth

Let us describe each of these functions briefly.

Primary Functions

1) Money as a **medium of** exchange : It is the most important and unique function of money which separates it from near-money assets. The use of money as a common medium of exchange has greatly facilitated the activity of buying and selling goods and services. Without money, exchange could be possible only through barter system whose basic weaknesses have been discussed earlier in this Unit On the other hand, the use of money as a medium of exchange avoids most of the problems of a barter exchange.

   Though use of money splits exchange into two parts, viz., sale and purchase, but it does not result in loss of time and energy.

2) Money as a measure of value : Money serves as a yardstick to measure values of all other goods and services in terms of their money price. In the absence of money, value of one commodity could be expressed only in terms of the other goods and services. As shown earlier, if there are, say, one hundred goods in the market, then under the barter system value of each product will have to be expressed in terms of the remaining 99 goods, i.e. in all there would be 4950 values. On the other hand, if money is used as a measure of value, then we need to measure value of each good in terms of money only, i.e. just 100 values for 100 goods. Further, there are goods which are expressed in different physical units, e.g. a metre of cloth, a kilogramme of wheat, a litre of milk, etc. Comparison of values of such goods is also possible if we know the money value

of these goods. For example, one metre of cloth is equal to 6 kg. of wheat or 3 litres of milk because they cost the same amount of money etc. The use of money prices also help us in estimating national income by adding up values of a wide variety of goods and services which are measured in different physical units and hence, cannot be lumped together to estimate national Income. Also, the use of money makes it possible to compare value of goods over time and between different regions.

However, money as a measure of value can serve satisfactory only when its own value (i.e., purchasing power) remains stable over time. Continuous rise in general level of prices all over the world has made money a poor measure of value.

Secondary Functions

1) **Money as a standard** of deferred payments : Money facilitates not only the current transactions of goods and services but also their credit transactions. It facilitates credit transactions when present goods are exchanged against future payments. In the modern world, the bulk of deferred payments are stipulated in money terms only. Examples in this regard are repayment of loan alongwith interest, pensions, rents, salaries, insurance premio, etc. Money could be an effective standard of deferred payments only if value of money itself does not change. If prices increase or decrease sharply, resulting in large fluctuations in the value of money, it would make money a poor standard of deferred payments.

2) Money as a store of value : People can hold a part of their present earnings in the form of money to be spent in future. Money represents generalised purchasing power and is a perfectly liquid asset as well. Besides, it is durable and more stable in its value. It is easy to store as it is relatively light in weight and occupies less space. Hence, it is convenient to accumulate wealth in the form of money which can be converted into any asset at any time. In this way money serves as a bridge from the present to the future, as money saved today implies shifting of purchasing power from the present to the future.

3) Money as a means of transferring purchasing power : Money is the most convenient form in which value can be transferred from one person to another and also from one place to another. It is because money is readily accepted by all and its cost of transfer from one place to another is very low due to its high value and less weight compared to other goods. For example, a person can transfer crores of rupees to another person at a distant place with the help of a bank draft or a cheque almost at a nominal cost. But transferring this value in terms of, say, rice is obviously very difficult, costly and involves wastages.

Contingent Functions

1) **Distribution** of national income : Money helps in the distribution of national output among the people who have contributed in its production. In a modern society people co-operate together as workers, owners of capital, landlords, etc., to produce goods. The resultant output is, therefore, to be distributed among all of them in the form of wages and salaries, interest, rent, etc. In the absence of money it would not always be possible to distribute such an output, particularly in case of indivisible goods, e.g. a machine. With the help of money we can overcome such a problem. .

2) Basis of credit system : The modern economy is based on credit i.e., promise to pay. The present day money itself (coins, currency notes, cheques, bank drafts, etc.) is nothing but only promise to pay. However, this money also helps banks to create more money by the process of credit creation, when the banks expand secondary deposits with the help of cash deposits (you will study this in Unit 5). In this way money serves as a basis of credit creation by banks.

3) Maximisation of utility and profits : Money helps consumers in maximising their satisfaction. When money is allocated between different goods and services, the consumer maximises his utility. Likewise, producers can calculate money cost of production and then decide the price that can result in maximum profits,

4) Money imparts liquidity and uniformity to assets : It is convenient to hold wealth in the farm of money as it is the most liquid of all assets. Money can buy any asset and all assets can be converted into money as well. Thus, money

imparts liquidity to all assets. Besides, total wealth of a person or a country can be assessed by adding up money values of all assets. Thus money also brings an element of uniformity to the wealth of the nation.

1.7 SIGNIFICANCE OF MONEY

Money is the life blood of a modern capitalist economy. Without money this economy cannot function smoothly. Just as the strength and vitality of a human body is judged by the amount of blood and its proper circulation, in the same way the strength and extent of development of the economy can be judged by the requisite supply and proper circulation of money in the economy. The significance of money, to a great extent, depends upon and is derived from the various functions it performs. These are given below :

1) Significance of money in consumption : Nowadays people receive their incomes in terms of money. This facilitates in exercising Free choice of consumption. Though, given their limited money income the consumers cannot buy each and everything that they desire yet money income gives them freedom to buy such goods and in such quantities which can yield them maximum satisfaction within that income-limit Besides, money gives the consumers liberty to choose between the present and the future consumption, i.e. how much to be spent on present consumption and how much to be saved from the given present income for Future consumption.

2) Significance of money in production: Money is not a factor of production, yet it facilitates production Use of money has led to expansion of market of goods and services. This has resulted in large scale production and technological improvements, thus minimising the cost of productipn. I- ow ever, large scale production requires division of labour and specialisation which is impossible under a barter-system. Besides, money (through price mechanism) indicates to producers the type and quantity of goods they should produce.

3) Significance of money in trade: Being a medium of exchange, money facilitates trade as well. Money constitutes basis of price-mechanism and, thus, helps in determining prices of goods and services through the forces of demand and supply. Besides by equalising marginal cost with marginal revenue of each product (measured in terms of money), the sellers can arrive at profit-maximising level of sales of their products.

4) Significance of money and economic progress : Introduction of money has led to the emergence of large scale production resulting in constant urge to accumulate capital and develop new techniques of production. Thus, the role of money in encouraging material progress is significant

5) Significance of money in public finance : Governments require resources to run the administration smoothly for which they levy taxes and also charge fees, fines, etc. Without money, taxes received will be in the form of goods which may or may not be useful from government's point of view, e.g., shoemaker paying tax in the form of shoes and green-grocer in the form of vegetables. But taxes received in money give freedom to government regarding choice of things which government needs for the developmental purposes.

6) Money and foreign trade : Money has helped in the expansion of foreign trade and thereby raise the levels of consumption the worldover. It is because with the help of money we can transact not only those goods which are produced domestically but also those which are produced by other countries. The possibilities of exports and imports with the help of money has resulted in expansion of international trade and co-operation.

The significance of money in all walks of life is so immense that modem life without money cannot even be imagined. It has rightly been remarked that 'money is a pivdt around which all economic activities cluster'.

1.8 EVILS OF MONEY

Invention of money has not proved to be an unmixed blessing as its use has become a source of so many evils too. If money is not used properly, it can create havoc and may prove to be disastrous for the mankind. Some of the evil effects of money arc listed here.

Economic Defects

1) Use of money has given rise to greed and exploitation of poor which has resulted in greater inequalities of incomes and wealth. History shows that it is the economic exploitation that triggers any social upheaval.

2) Money helps in extending the scale of production, which after certain limits may result in a situation where production far exceeds the demand. This leads to fall in level of prices, unemployment, decline in incomes and thereby misery for the masses.

3) By facilitating borrowing and lending, money may encourage overcapitalisation (i.e., using too much capital in place of labour) in production, thereby creating large scale unemployment in the economy.

4) When a government/central bank increases the supply of money by simply printing new notes, it leads to sharp rise in prices. This adversely affects the purchasing power of fixed income groups in the society, resulting in class-conflicts and social disorder.

Social Defects

1) Money has encouraged many kinds of anti-social activities like gambling, fraud, robbery, etc.

2) It makes people greedy and acquisitive.

3) It encourages tendencies of exploiting others.

However, it cannot be denied that most of the evils listed above arise because of improper use of money; these are not evils of money itself. Hence, there is a greater need to use money as a faithful servant than to become slaves ot money and invite troubles. It has been rightly remarked that tnoney which has been source of so many blessings tomankind becomes a source of peril and confusion unless we control it.

Check Your Progress B

1) List some of the important functions of money.

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2) What are the main evils of money ?

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3) Which of the following statements are True and which are False ?
   i) Money is a perfect measure of value.
   ii) By making capital mobile, money helps in large scale production.
   iii) Money facilitates in exercising free choice of consumption.
   iv) It is only money that causes exploitation of the poor.
   v) Money helps in the expansion of both domestic and foreign trade.

4) Match the function (as given in Column B) that money performs when the following things (as shown in Column A) happen.

Column A	Column B
a) You are told that price of Sugar is Rs. 10 per kg.	i) Medium of exchange

b) You pay Rs. 10 and buy a kg of sugar. ii) Store of value

c) You buy a national saving certificate from post-office for Rs. 100 which promises to repay after 6 years. iii) Measure of value

d) A person keeps apart Rs. 100 from his salary as his saving. iv) Standard of deferred payments.

1.9 LET US SUM UP

Modem economy is a monetary economy where money is used freely and widely in all spheres of life. Before the advent of money there was barter-system of exchange. Barter created many problems which not only made the process of exchange difficult but also forced the producers to produce on very small scale due to small size of the market. These limitations of barter ultimately led to the invention of a common medium of exchange, called money.

Money can be anything which is chosen by common consent and is generally acceptable as means of payment. Money had to pass through many stages, i.e., commodity money, metallic money, paper currency, bank money, etc. At present paper currency and bank money form the bulk of total money supply.

In the modem times money is only a claim with nearly zero intrinsic value. It is widely accepted due to the fiat (i.e., legal backing of the issuing authority) or else it is only a piece of paper. The demand for money also stems from the fact that it is the perfectly liquid asset and hence the most convenient form in which wealth can be stored Another form to store wealth is near-money assets which are highly but not perfectly liquid, as they have to be first converted into money before any transaction of goods and services can be undertaken.

The importance of money lies in the functions that it performs. The most important functions which money performs are : i) medium of exchange, ii) measure of value, iii) standard of deferred payments, and iv) stork of value. However, apart from these four functions money also helps in many other ways, like distribution of national income, transfer of value, basis of credit creation, maximisation of utility and profits and imparting liquidity and uniformity to assets.

Money has influenced all branches of economic activities such as consumption, production, exchange, international trade, public finance, etc. The net impact of the use of money has been a sharp rise in the production of goods and services, and thereby achieving higher levels of consumption for the people. Besides, it has helped raise efficiency through greater division of labour, specialisation and technological change, resulting in higher level of national income. Money has helped tremendously in the expansion of foreign trade.

However, money has also created such conditions whereby there is a greater scope for exploitation of labour, leading to class-conflicts and industrial unrest. Use of money has also given rise to all kinds of social evils, like theft, dacoity, frauds, etc. by encouraging greed and acquisitiveness. Above all, sharp fluctuations in value of money prove harmful for the progress of trade and industry.

1.10 'KEYWORDS

Barter System : The system of direct and mutual exchange of goods and services.

Chequable Deposits : Deposits with banks which can be withdrawn at anytime by issuing a cheque.

Fiat Money: Money that people have to accept as it has legal backing.

Intrinsic Value: The value of metal that the coin contains.

Liquidity: Quality of the asset by which it can be readily converted into any other asset

Specialisation of Labour: A system of production when a worker looks after a specific part of the production process, rest of the process being looked after by others.

1.11 'ANSWERS TO CHECK YOUR PROGRESS

A 3 i) Lack of double coincidence of wants
ii) Problem of common measurement of value
iii) Loss due to sub-division of goods
iv) Difficulty in store of wealth
4 i) True ii) False iii) True iv) False v) True
B 3 i) False ii) True iii) True iv) False v) True
4 a) iii b) i c) iv d) ii

1.12 TERMINAL QUESTIONS

1) What is money? Distinguish between money and near-money.
2) Explain briefly the inconveniences of barter-system and trsce the evolution of money.
3) Discuss the nature and functions of money.
4) Bring out the importance of money in a modern capitalist economy. Can money be abolished?
5) 'Money is a good servant but a bad master'. In the light of this statement highlight the evils of money.

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.

UNIT 2 DEMAND FOR AND SUPPLY OF MONEY

Structure

2.0 OBJECTIVES

After studying this Unit, you should be able to:

- explain the concepts of demand for and supply of money
- state why money is demanded
- identify the various determinants of demand for money
- discuss the basic differences in the various theories relating to demand for money
- distinguish between the conventional and the modern concepts of money supply.

2.1 INTRODUCTION

In the previous unit you learnt about the nature and importance of money in modem complex economies. You also learnt that money performs four basic functions, viz., it is a medium of exchange, a unit of measurement, a standard of deferred payment, and a store of value. But the fundamental reason why money can be used for these functions is that the public considers money as an asset representing a claim over goods and services. Like any other asset, money is demanded and supplied. In this unit, we will discuss the concep'ts of demand for and supply of money, various theories relating to demand for money, and the conventional and modern concepts of money supply.

2.2 MEANING OF DEMAND FOR MONEY

Money is a stock variable, The money stock is the quantity of money at a point of time. As an asset, money is demanded because public desires to hold it. The motive for holding money and the time period for which it is held, of course, may differ from individual to individual. A person may hold cash for spending on goods and services. He may also demand money for hoarding it, i.e. keeping idle cash. **Demand for money in an economy is,** thus, the sum total of money demanded by all individuals/households in that economy.

The theory of demand for money addresses itself to the following two fundamental questions:

1) Why does an individual/household want money?
2) What are the main determinants of demand for money?

Several explanations have been offered in reply to these questions, known as theories of demand for money. Let us discuss those theories now.

23 THEORIES OF DEMAND FOR MONEY

There are two main approaches to explain the demand for money: 1) the classical approach, and 2) the Keynesian approach. Related to classical approach is the neo-classical theory, which is based on the same assumptions but different determinants when compared to the classical theory.

2.3.1 The Classical Approach

This theory is often associated with economists like J.S. Mill and Irving Fisher. According to them, people demand money because every individual and business firm gets money by selling goods and services (including factor services) and in turn use this money for the purchase of goods and services produced by others. Hence, from the view point of classical economists, people wish to hold cash balances in order to carry out day-to-day transactions. The amount of money demanded by an individual or a business firm therefore, depends upon the volume of transactions. Since there is a fairly stable relationship between the level of income and the volume of transactions, the former is taken as an approximation for the latter.

2.3.2 The Neo-classical Theory

The early neo-classical theory of the demand for money was put forward by the Cambridge economists Alfred Marshall and A.C. Pigou. That is why the neo-classical theory is also called the *'Cambridge Equation* Approach'.

According to Cambridge approach, a proportionate relationship exists between the 'demand for money' (M^d) and the 'money value of national output' (Y). Demand for money function, therefore, takes the form:

$$M^d = KY \quad \ldots\ldots (1)$$

where K is a constant ($0 < K < 1$).

It may be seen from Equation (1) that $K = \frac{M^d}{Y}$, i.e.

the demand for money per rupee of income (per unit of time). In other words, the Cambridge K would show the proportion of income which, on average, the public

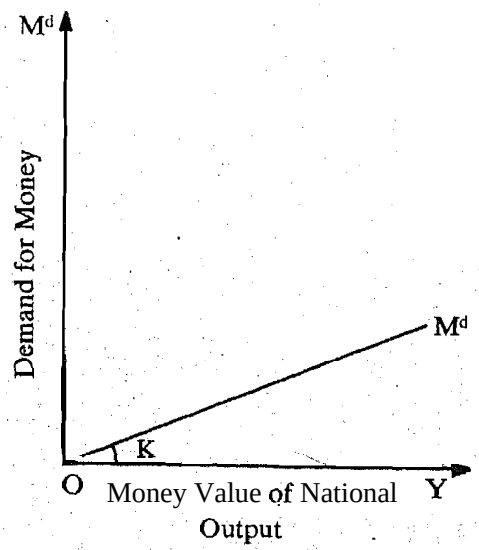

Fig. 2.1. Demand for Money Function

would like to hold in the form of Money. This is represented in Figure 2.1. where changes in demand for money are in direct proportion to the changes in Y — the proportion between them being equal to K. It may be noted that Cambridge Equation specifies the demand for money as a function of money income alone.

Equation (1) may be rewritten as

$M^d = K. P, Y$ ..... (2)

where P = general price level
Y = real national income

Equation (2) gives us the demand function for real money. One of the key features of this equation is that it shows a proportionate relationship of M^d with P and y. It implies that any change in the general price level or in real national income would lead to an equal proportionate change in the demand for money, i.e., the income elasticity as well as the price elasticity of demand for money are both equal to unity. It may be noted that the neo-classicals have postulated a very simple function of demand for money which has been fruitfully applied in the development of quantity theory of money.

A comparison of the classical and neo-classical theories of demand for money reveals that, though the basic assumptions of these theories are similar, yet they differ from each other in one important way : the classical approach was concerned with the volume of total transactions, while the Cambridge approach focused primarily on the level of income.

Check Your Progress A

1) Explain the concept of demand for money.

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2) Point out similarities and dissimilarities of the classical and neo-classical theories of demand for money.

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3) Which of the following statements are True and which are False ?
   i) Money is mainly demanded by the public.
   ii) The classical theory postulates that money is demanded because it functions as a medium of deferred payments.
   iii) According to the Cambridge approach demand for money changes in direct proportion to changes in the money value of national product.
   iv) Public considers money as an asset representing a claim over goods and services.

233 Keynesian Theory

John Maynard Keynes gave his own formulation of demand for money in his well-known book, The *General Theory of Employment,* Interest and Money. Some of the economists who agreed with the Keynesian framework of analysis helped in further development of Keynesian theory of demand for money.

Keynes began by asking the following two inter-related questions :
i) Why is money demanded ?
ii) What influences the demand for money ?

His answers to theae questions gave us the Keynesian Theory of demand for money, Now let us study the answers to these questions.

Why Is Money Demanded ?

We know that money in hand does not earn any income. On the other hand, there are always certain competing non-money assets which give some returns to their holders. The fundamental question that arises, therefore, is: what is the motive of holding assets in the form of money ? Its genera! explanation is that, money being the only commonly acceptable means of payment, it has the advantage of being perfectly liquid, which is not there in case of other assets. Keynes put this idea in more concrete form when he classified the motives for holding money into three categories : a) transactions motive, b) precautionary motive, and c) speculative motive.

In order to meet current transactions of all kinds, people hold some cash, l|known as transactions demand for money ; while they demand money for precautionary purposes when they hold it to provide for contingencies and unforeseen profitable opportunities. Cash held over and above that needed for transaction and precautionary purposes is known as speculative demand for money. The detailed discussion of these three motives is given below.

The Determinants of Demand for Money

1) The transactions motive

The time of receiving income and the time of incurring expenditure by an individual/firm generally do not coincide. In order to meet the needs of transactions during this time gap some money is kept aside, known as the transactions demand for money. The smaller the time *gap* between a person's receipts and payments, lesser will be the transactions demand for money. Let us understand this with the help of an illustration. Two individuals, A and B who had the same salary per month say Rs. 4,000. Individual A is paid Rs. 4,000 on first day of every month, while B is paid Rs. 1,000 on first day of every week (making an aggregate of Rs. 4,000, assuming exactly four weeks in a month). Assuming that the each individual spends his income each day in such equal amounts that at the end of the income-period they are left with zero cash balance. The pattern of transactions balance of the two individuals is shown in Figure 2.2. The above assumption implies that the average transactions balance during the income-period would be equal to half of the income of that period. Individual A would therefore, have a transactions balance of Rs. 4,000 X 1/2 = Rs. 2000, while transactions balance of individual B would be Rs. 1,000 X 1/2 = Rs. 500.

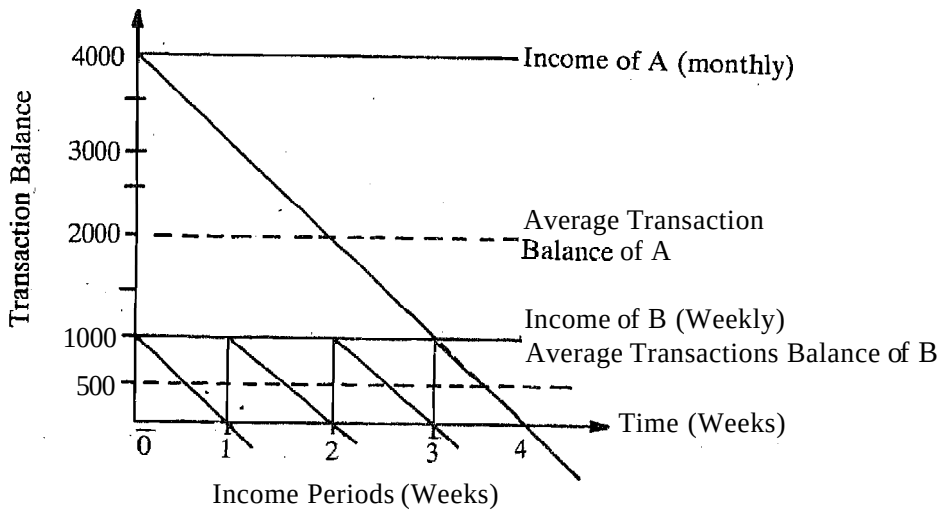

Fig. 2.2 The Transaction Demand for Monay and the Income-period.

However, the assumption of an even distribution of expenditure over the income-period seems very simplistic. Certain payments like the monthly bills for electricity, water, telephone, house rent, children's school fee, etc., and other lump sum payments are generally made at the beginning of the month Cash holdings, therefore, decline rapidly during the early part of the income period.

Business firms also need cash for meeting their day-to-day transactions. But their receipts and payments are not as regular as those of the households. Compared to households, therefore, the firms must keep relatively larger cash balances at any point of time.

From the above analysis, it is clear that the transactions demand for money depends upon the volume of transactions, which are directly related to the level of income. This relationship between the transactions demand for money (L_1) and the level of money income (Y) is expressed as :

$$L_1 = f(Y) \quad \ldots\ldots(3)$$

For simplification it is assumed that the relationship expressed in Equation (3) is stable over time. This is diagrammatically shown in Figure 2.3, where transactions demand for money increases in direct proportion to the increase in income.

Apart from income. certain other factors are also relevant to the transactions demand for money in the long run. For example, if a particular society decides to change its payment period from monthly to weekly, the average amount of cash held per day will decline significantly. In a similar manner, the level of monetisation in developing countries is yet another factor to be taken into account. As barter transactions decline. more cash is needed to facilitate transactions.

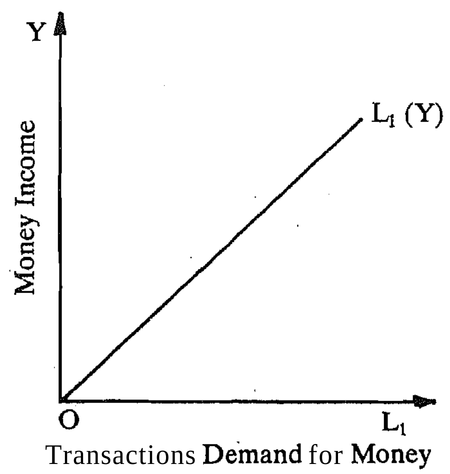

Fig. 2.3 Transactions Demand for Money Function

Keynes treated transactions demand for money as a function of income alone. However, later economists attempted to show that the transactions demand is affected by the changes in interest rate also. At higher rates of interest, transactions demand is interest-elastic, as a high rate of interest implies higher opportunity cost of holding money, i.e., higher sacrifice in terms of interest income. It is at very low rates of interest that transactions demand is interest-inelastic. However, Keynes believed that money for transactions purposes is held mainly ,for the sake of convenience and not for earning interest. The interest-inelastic transactions'demand is shown in Figure 2.4.

2) The Precautionary Motive

The precautionary demand for money arises mainly due to the uncertainty of future receipts and expenses. The cash held by an individual/firm helps in meeting unexpected fall in receipts or rise in expenditure or both in future.

Like transactions demand, precautionary demand for money also is related to the level of income, and varies directly with it Compared to a small firm, a firm having high turnover needs more cash in hand In a similar manner, a rich man generally needs a larger amount of cash for precautionary purposes. A firm's precautionary demand for money is influenced not only by the level of income of the firm but also by factors like political situation and business conditions prevailing in the economy. If the political situation is unstable or the business conditions look bleak, there will be greater demand for precautionary balances, and *vice versa,* It may be noted that since precautionary demand for money is generally found to be directly related to the level

of income, Keynes clubbed such demand for money with the transactions demand for money.

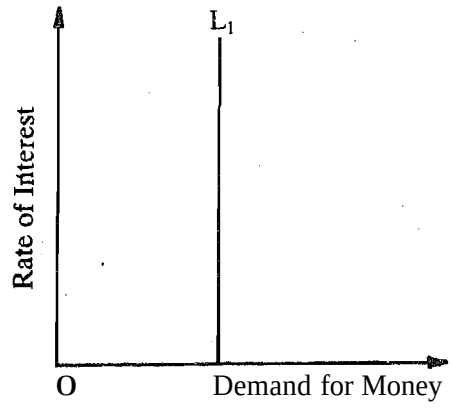

Fig. 2.4 Relation between interest and transaction demand for money.

3) **The** Speculative Motive
The Keynesian proposition that the money is held for transactions and precautionary purposes does not conflict with the classical theory : a transactions balance is nothing but money s ving as the medium of exchange. Same can be said for the precautionary balances also. However, the third motive introduced by Keynes, viz., the speculative motive for holding money, represents a distinct break from the classical theory. The speculative demand for money also sometimes called the 'asset demand for money'.

According to the speculative motive, money is demanded as an asset to make speculation in bonds which are long-dated government securities. The speculative demand for money comes from the people who desire to make capital gains by buying bonds when their prices are low and selling them when their prices rise. People holding speculative balances keep anticipating about the behaviour of bond prices in future. If they expect bond prices to fall in future, they hold speculative balances so as to be able to buy the bonds when their prices actually fall and sell them when their prices actually go up.

The bond prices (or the capital value of bonds) are inversely related to the rate of interest. A fall in the interest rate will lead to an increase in the bond prices, and *vice* vena Suppose a Rs. 100 bond yields an annual return of 5%. Let us say the market rate of interest goes up to 10%. Since the return on this bond has reduced to half compared to the market interest rate, the price of bond (or the capital value of bond) will naturally reduce to Rs. 50. Since the bond prices are affected by the interest rate changes, the speculative demand also becomes a function of the interest rates and there is an inverse relationship between the two. There are two reasons for this inverse relationship :

1) As mentioned earlier Keynes considered holding bonds as an alternative to holding cash. Given a choice between bonds and money, the higher the rate of interest, the greater is the opportunity cost of holding cash Hence, at higher interest rates more bonds and less cash are held
2) An important reason for the inverse relationship is the existence of expectations. At high interest rate it is expected that the interest rate will fall. A fall in interest rate would mean an increase in the price of bonds. If the price of bonds is expected to go up in future, people buy more bonds now, resulting in decline in cash balances. This inverse relationship between

speculative demand for money and rate of interest is shown in Figure 2.5. As rate of interest declines, the demand for speculative balances increase. Eventually a stage may come when rate of interest becomes so low that people prefer to hold the whole of their assets in cash only. In other words, Keynes suggested that at a certain very low rate of interest, the speculative demand for money becomes perfectly elastic. This is known as liquidity trap. In Figure 2.5 such a situation arises when the rate of

interest falls down to r* — this is the limit below which the rate of interest cannot fall. The flat part of the curve indicates that the expectation about the future fall in . bond prices is so universal that everyone will hold cash and not bonds. The situation is important from the point of view of the tnonetaty policy. If the economy is in liquidity trap, it would mean that even the money supply is increased, the rate of interest will not fall as the economy is already operating at the minimum rate of interest

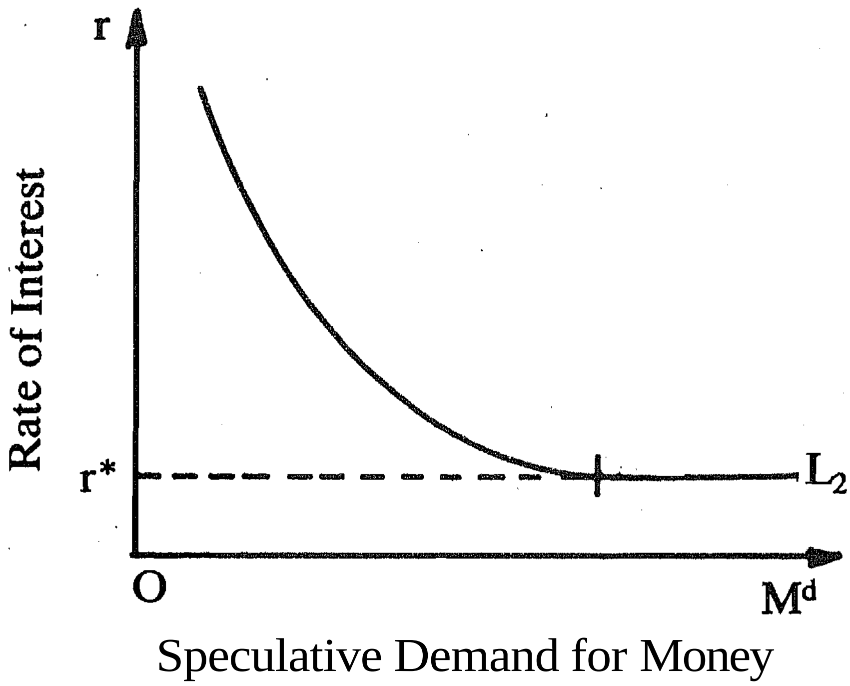

Fig. 2.5. Keynes' speculative demand for money.

Another important element in the Keynes' Theory of speculative demand is the concept of 'normal rate of **interest'**. According to Keynes, at any particular time period, there exists a certain 'r' which the speculators consider as 'normal', **i.e., the** rate of interest which will prevail in the market under **normal** conditions. It is in relation to this normal rate that the current rate of interest is judged as low or **high. A** rate higher than the normal rate of interest will produce expectations of its fall in future, and vice-versa. Hence, the speculative demand for money depends on the current rate of interest in relation to the normal rate.

It will be relevant here to make distinction between active and idle cash balances, as given by Keynes. The active balances are those which are used as means of payment for meeting transactions, while the rest are idle balances. The transactions and precautionary demand for money are sometimes called the demand for active balances, while money demanded for speculative purposes is called the demand'for idle balances.

Total demand for money

According to the Keynesian Theory, the total demand for money M^d is composed of L_1 and L_2; i.e.

$$M^d = L_1(Y) + L_2(r) \quad \ldots\ldots\ldots\ldots\ldots\ldots (4)$$

Where, L_1 (Y) represents the transactions and precautionary **demands** for money, both of them being an increasing function of the level of money income (Y). The third component, viz., **L2** (r), represents the speculative demand for money which is a declining function of rate of interest (r). Equation (4) is an additive function of demand for money showing that the demand for money is the sum of interest-inelastic component of transactions and precautionary demands (L_1) and interest-elastic

component of speculative demand (L_2). This is shown in Figure 2.6.

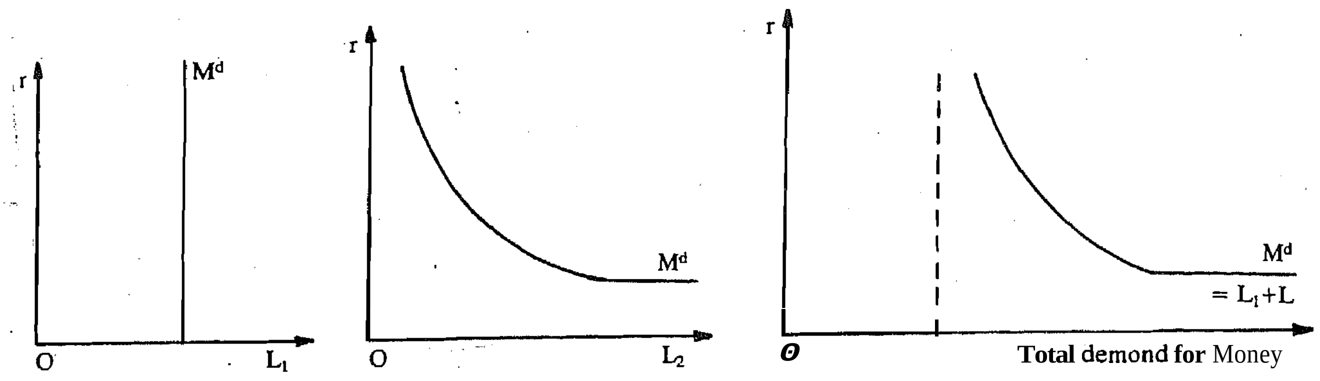

Fig. 2.6. Total Demand for Money (i.e., $L_1 + L_2$)

However, the post-Keynesian economists believe that money is one asset only and the same unit of money can serve all the three motives. So the demand for money , cannot really be compartmentalized into different motives as shown by the additive' function. Economists like **Tobin** and Baumol have tried to show that transactions demand for money is not only income-elastic but is also interest-elastic. The same argument can be given for the precautionary demand also. On the other hand, the speculative demand can be shown as an increasing function of the total wealth Taking income as a proxy for wealth, the speculative demand can also be shown to depend upon both the rate of interest and the level of income. In the light of this, we can modify Equation (4) as:

$$M^d = L(Y, r) \quad \ldots\ldots (5)$$

In Equation (5) demand for money (M^d) is positively related to Y and negatively related to r.

Check Your Progress B

1) What is the main difference between the classical and the Keynesian theory of demand for money ?

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2) Explain briefly the speculative motive for holding money,

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3) What is a 'liquidity trap' ?

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4) Which of the following statements are True and which are False ?
   i) Idle cash balances are used for meeting transactions.

ii) There is a negative relationship between the level of income and the transaction balances.
iii) The speculative demand for money is inversely related to the level of income.
iv) Monetary policy works very effectively in the situation of liquidity trap.

2.4 THE SUPPLY OF MONEY

2.4.1 What is Supply of Money?

Supply of money in an economy at any point of time refers to the volume of money held by the households and firms for transactions and settlement of debts. In the generally accepted measures of money supply we do not include the money held by the government and money lying with the commercial banking sector. This is done mainly to separate the producers of money (i.e. government and banking system) from the demands of it (i.e., the households, firms and institutions).

The supply of money at any point of time consists of:

1) Currency: It consists of both paper currency and the coins in circulation. The former is in terms of currency notes of the denomination of rupees two and above issued by the central bank, i.e. Reserve Bank of India, and rupee one notes issued by the Government of India.
2) Net **demand** deposits: Total demand deposits with banks include deposits from public and those deposits which one bank holds with other banks (viz., inter-bank deposits). Only the former component of total demand deposits are included in supply of money, as money, by definition, is something held by public.
3) 'Other deposits' with Reserve Bank of India: They include demand deposits of quasi-government institutions, foreign central banks, foreign governments, the World Bank, etc. This component of money has been a very negligible proportion of total money supply in India.

The conventional measure of money supply (known as M) includes coins and currency notes in circulation with the public and the net demand deposits. This measure is often referred to as a narrow measure of money supply.

In modem literature on money supply, distinction between money and liquidity has been emphasized. In this context, it may be found that it is not only money (in the conventional sense) but also near-money that is part of the liquid assets available with the public for spending. People's ability to spend, therefore, depends upon the amount of overall liquidity in the economy which depends both on the total stock of money as well as near-money assets. In the near-money assets we include:
i) savings deposits with post office savings banks and commercial banks, bnd ii) time deposits of the banks (net of inter-bank deposits).

We know that cheque facility is available against the saving deposits, which adds to liquidity. Similarly, fixed deposits can be prematurally encashed or a 'loan can be taken against them. Both these options result in greater liquidity.

Till 1967-68, the Reserve Bank of India defined money supply only in the conventional manner (i.e., M). But from 1967-68, it also started publishing a broader measure of money supply and called it aggregate monetary resources (AMR). Since 1977, the RBI has added two other measures of money supply, called M_2 and M_4. These four alternative measures of money supply, as given by the RBI, may be stated as:

M or M_1 = currency held by the public + demand deposits of the public
M_2 = M_1 + savings deposits with post office
AMR or M_3 = M_1 + time deposits of banks held by the public
M_4 = M_3 + total post office deposits

Both M_1 and M_3 are conceptually the same as M and AMR respectively. However, these differ in their coverage. M_1 and M_3 measures of money supply give a better coverage to the co-operative banking sector than do M and AMR.

Poet office savings deposits are far less liquid than commercial bank savings. Savings

deposits with post office can be withdrawn on demand, but have the following restrictions:

1) Chequable portion of these deposits is very small.
2) There are restrictions on number of withdrawals in any week.
3) There is a maximum limit on the amount of any single withdrawal{unless an advance notice is given to the post office).

Consequently, post office savings deposits cannot serve as a medium of exchange and are less liquid than the savings deposits with the commercial bank. It is with a view to *treating* post office savings deposits as separate from the commercial bank savings deposits that M_2 and M_4 series of money supply are provided by the RBI.

2.4.2 Agencies Influencing Money Supply

Money supply with the public is influenced mainly by the central bank of the country and its commercial banks. Through its fiscal policy, the government also affects, to some extent, the supply of money.

The Central **Bank** and **Money** Supply: The central bank of a country affects money supply both directly as well as indirectly. It is directly responsible for the issue of currency notes and coins. On the other hand, it can indirectly influence the deposit component of the money supply. We know that a commercial bank can create deposits keeping in view its cash balances. If the central bank uses methods to reduce the supply of cash balances with the commercial banks, the latter will be able to give less loans and advances and create less deposits. The opposite will be the consequence if the central bank uses its power to increase the cash balances with commercial banks. In order to achieve this, the central bank uses various control instruments, like changes in statutory reserve requirements of commercial banks, changes in interest-rate structure of banks, open-market operations, lending policy towards commercial banks, etc.

Commercial banks and money supply: Commercial banks can create demand deposits or bank money. These deposits are created in two ways:

1) When people deposit their cash with the banking system, they convert their 'cash in hand' into demand deposits. These deposits are known as primary deposits.
2) The cash brought into the banking system through these primary deposits is then either used to buy financial assets from the market (e.g. bills, bonds, etc.) or lent to industry and business. We know that when any bank lends to a customer, it does not give cash to him; instead the bank credits the loan amount to the customer's account, thus creating demand deposits in his name. Since these deposits have been created on the basis of primary deposits these are known as derivative deposits. If banks are able to grant more loans on a given amount of primary deposits, it would result in more bank money. It must be noted that time deposits do not become the basis of credit creation because time deposits are not used as a means of payments — these are only savings for the specified period The capacity of the banking system to create bank money depends upon the following factors:
   i) Availability of cash with the banking system
   ii) Willingness to borrow from the banking system
   iii) Ratio of cash to bank deposits
   iv) Credit control policy of the central bank of the country

Government and money supply: The Government also affects the supply of money. Whonevor the government imposes taxes or borrows from the public, it reduces the volume of available money with the public. *On* the other hand, when government finds that its income through taxation and public borrowings falls short of its expenditure, it borrows from the central bank (against its own securities) to pay off its creditors. Consequently, the availability of cask with the public and the banking system will increase. As the availability of cash with the public and the banking system changes, so does the economy's capacity to expand or reduce credit.

It may, therefore, be concluded that the supply of money in an economy increases under the following situations:

1) when the public wants to hold less cash with themselves and is willing to borrow more from the banking system;
2) when commercial banks expand their credit operations;

3) when the central bank issues more currency or follows a monetary policy that helps in expanding credit.

2.5 THE VELOCITY OF MONEY

The discussion on supply of money referred to the quantity of money at a particular point of time. However, Irving Fisher and other exponents of Quantity Theory of Money were more interested in the concept of the supply of money over a period of time rather than at a point of time.

Fisher uses the concept of transactions velocity to find out the money value of total transactions during a given period. Transactions velocity is defined as the average number of times a unit of money changes hands for moneys activities during a given period For example, if a hundred rupee note passes five hands on average during a time period, it means that the hundred rupee note has served transactions worth Rs. 500. In this case, transactions velocity is equal to 5. Higher velocity of circulation implies smaller quantity of money required to meet a given money value of total transactions. Transactions velocity of money depends upon the payments practises and other structural features of the economy. Since these determinants are found to change slowly, the transactions velocity is also considered as slow changing.

With the development of national income accounting techniques, the transactions velocity gave place to income velocity of money. Income velocity of money is defined as the average number of times a unit of money is used for making payments for final goods and services only. Obviously income velocity of money will be smaller than transactions velocity because the latter refers to all transactions. Income velocity of money depends upon the structural factors like payments practices, the business organisation and the working of the mechanism for transferring payments in the economy. Income velocity of idle money balances (e.g. hoardings) in an economy is zero. Greater the share of idle balances in the total money stock, the smaller will be the share of the total money stock available to finance purchases of final goods and services, resulting in low income velocity of money.

Check Your Progress C

1) Supply of money consists of

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2) Distinguish between the various ineasures of money supply given by the RBI,

M_1 = ...

M_2 = ...

M_3 = ...

M_4 = ...

3) Which of the following statements are True and which are False ?

i) Total stock of money in an economy determines the overall liquidity in the economy.

ii) M_1 and M_3 differ in coverage when compared to AMR.

iii) Post office savings deposits are far more liquid than commercial bank savings deposits.

iv) Commercial banks use primary deposits to create credit.

v) The money held by the government is not included in the measure of money supply.

2.6 LET US SUM UP

Money forms an integral part of any modern economic system. The two major functions of money are : 1) as the medium of exchange and 2) as the store of values. The reason why people desire to hold cash in hand can be explained in terms of three motives, viz., the transactions, precautionary, and speculative motives. The first two motives relate to the medium of exchange characteristic of money, while the third (i.e. the speculative motive) to the store of value feature of money. The classical and the neo-classical economists concentrated only on the first two motives, whereas Keynesian theory of demand for money incorporated all the three motives. The third motive was solely introduced by Keynes and it represented a major breakthrough in monetary theory.

Money supply, or more precisely the stock of money in an economy, is the money held by the public (i.e. individual firms and institutions) at a point of time. Several measures of money supply have been introduced by the Reserve Bank of India, viz., M_1, M_2, M_3 and M_4. Of these, M_1 had been the most commonly used measure of money supply prior to 1978. It consists of the currency and demand deposits held by the public. However, after 1978, M_3 measure (which includes the net time deposits of banks) has replaced M_1 as the popular measure. The former measure is called the narrow definition of money supply whereas the latter measure, i.e. M_3, is called the broader definition of money supply. However, it needs to be noted that these measures differ only in terms of their coverage but not the concept.

There are basically three agents that influence the money supply in an economy. These are : the central bank of an economy, the commercial banks and the government. The central bank affects money supply not only by issuing currency notes and coins but also through its monetary policy including its control over credit creation. Based on the amount of primary deposits, the commercial banks create derivative deposits and create credit. Government of a country can also influence the money supply by following different taxation, public borrowing and expenditure policies.

Velocity of circulation refers to the number of time a unit of money changes hands to fulfil transactions needs during a given time period. Transactions velocity of money is the average number of times a unit of money changes hands for all kinds of transactions in an economy during a specified period. Whereas, income velocity of money refers to the number of times a unit of money is used for making payments for final goods and services only during the specified period of time. Velocity of circulation is considered as slow changing.

2.7 KEYWORDS

Active and Idle Cash Balandes : The cash balances which are used as means of payment for meeting transactions are active balances. The rest are called idle balances.

Broader Definition of Money: The only difference between the narrow and broader definition of money is that of the net time deposits of the banks. The broader measure of money supply includes the net time deposits also.

Demand for Money: Money to hold on hand.

Liquidity Trap: A situation in the bonds market when the rate of interest falls to its lowest level and the speculative demand for money becomes perfectly elastic.

Narrow Definition of Money : A measure of money supply (given by RBI) which defines money as sum total of currency and demand deposits held by the public.

Normal Rate of Interest: The rate of interest that will prevail in the bonds market under normal conditions. It is in relation to this normal rate that the current rate is judged high or low.

'precautionary Demand for Money: The amount of money demanded for meeting unforseen increases in expenditures or delays in payments.

Speculative Demand for Money: Money demanded by the speculators to speculate in bonds so as to make capital gains by buying bonds when their prices fall and selling them when their prices rise.

Transaction Demand for Money: Money held to meet day-to-day or current transactions.

2.8 ANSWERS TO CHECK YOUR PROGRESS

A 3 i) True, ii) False, iii) True, iv) True
B 4 i) False, ii) False, iii) True, iv) False
C 3 i) False, ii) True, iii) False, iv) True, v) True.

2.9 TERMINAL QUESTIONS

1) Why is money demanded ? How is the Keynesian approach different from the classical approach in this regard ?
2) Discuss the various motives for holding money. Is demand for money a function of the level of income and the rate of interest ?
3) What are the various measures of the money supply used in India? **a** Which of these measures is most commonly used at present ?
4) How is the narrow definition of money different from the broader definition of money ?

Note: These questions will help you to understand the unit better. Try to write answers for them, But do not submit your answers to the university for assessment These are for your practice only.

UNIT 3 MONEY AND PRICES

Structure

3.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the factors which determine the value of money and price level
- justify the quantity theory of money
- differentiate between the cash transaction and cash balances approaches to the quantity theory of money
- outline the superiority of Keynes theory over classical theory of money
- analyse the restatement of quantity theory of money by Milton Friedman.

3.1 INTRODUCTION

The value of money differs from the value of other objects in one fundamental respect, that is the value of money represents general purchasing power or comman over 'things in general'. High prices of other things are reflected in the low exchang value of money. Similarly, low prices of other things mean high exchange value of money. The value of money is, therefore, the reciprocal of the general price level (p and can be expressed as 1/p.

One of the basic problems is to identify the factors which determine the value of money or to explain the causes responsible for changes in the purchasing power of money. In this unit, you will study various theories related to the value of money ar prices. In particular, we will discuss the quantity theory, Keynesian theory and Milton Friedman's quantity theory of money.

3.2 QUANTITY THEORY OF MONEY

Classical economists try to explain these changes in the general level of prices with the help of the 'Quantity Theory of Money'. This theory is generally associated wit the' name of American Economist Irving Fisher, though its origin can be traced bacl to Devin Zatti, an Italian writer of the 16th century, Bodin, Cantillon and Hume wl gave vigorous formulations of the idea embodied in the theory.

According to the Quantity Theory of Money the value of money depends on the quantity of money in circulation at a given point of time in the economy. Essentiall the quantity theory of money hypothesizes that changes in the general price level ar to be explained with reference to changes in the quanity of money in circulation. Sc

an increase in the quantity of money leads to an increase in the price level, while a contraction in the quantity of money leads to a decline in the general price level. In its orthodox version **the quantity theory states that, other things remaining unchanged, the changes in the general price level are directly proportional to the changes in the supply of money.** To cite Prof. Taussig, *'double the quantity of money and other things being equal, prices will be twice as high as before; and the value of money us one half. Halve the quantity of money, other things being equal prices will be one half of what they were before; and the value of money will be doubled.'*

The quantity theory of nioney has two approaches :
1) The Cash-transaction approach or Fisher's version
2) The Cash-balances approach or the Cambridge version.

Let us understand the basic difference between these two approaches.

3.2.1 Gash Transactions Approach

The Cash Transactions approach to the quantity theory of money is usually ascribed to Simon Newcome and Irving Fisher. Hence, this approach is also called 'Fisher's Equation'. Fisher explains changes in the general price level (P) with the help of changes in the quantity of money in circulation (M), its velocity of circulation (V), and volume of transactions (T) Fisher's equation of exchange reads as :

$$MV = PT \quad \ldots\ldots\ldots\ldots\ldots (1)$$

or, Aggregate supply of money = Total value of all goods and services

According to Fisher, the quantity of money in any economy depends upon two aspects : 1) the quantity of cash with the public (M), and 2) the velocity of circulation of the cash (V).

We know that in an economy cash does not remain idle (except when money is hoarded). In the event of a transaction money changes hands. **The average number of times a currency note changes hands during a given period of time is known as its velocity of circulation.**

Velocity of Circulation : For example, if a 100 rupee note changes four hands in a day, it has served the transaction needs worth Rs. **100** × **4** = **400.** Here we may say that though the cash (M) was only Rs. 100, the quantity of nioney (MV) was equal to Rs. **400.** However, all units of cash do not circulate at the same rates. Some currency notes circulate faster than the others, So, for finding the quantity of money in an economy, we need to estimate the **average velocity of money. When we multiply the average velocity of money with** the **quantity of cash in hand in the economy during the** year, **wc get the total money supply in the economy during that year.**

It is a common knowledge that money is demanded mainly for the purposes of transactions. The total demand for money would, therefore, be equal to the total value of goods and services transacted during a, given period. The latter would in turn be equal to the volume of goods and services transacted (T) multiplied by average price of these goods and services (P).

Equation MV = PT which we have stated earlier may also be rewritten as :

$$P = \frac{MV}{T} \quad \ldots\ldots\ldots\ldots\ldots (2)$$

The above equation implies that the price level at a given point of time may be taken as the ratio of total money supply to the total volume of goods and services transacted at that time.

Assumptions : Fisher's version of quantity theory of money is based ,on the following three assumptions :

1) It assumes that the velocity of money (V) is constant and is not affected by the changes in the quantity of cash (M) or the price level (P).

2) It is also assumed that the volume of goods and services (T) remains constant as it depends on the size of natural resources, climatic conditions, techniques of production, productivity of labour, transportation facilities, etc. The constancy of total volume of goods and services transacted (T) is based on another assumption

that there exists full employment in the economy, i.e., there are no unemployed productive resources which can be used to increase production of goods and services to be exchanged for money.

3) In quantity theory of money the variable price (P) is a passive factor. It is affected by other factors in the equation, but not vice versa. Thus, the association between price (P) and other factors in the equation is only one-sided in as much as P is determined by other elements in the equation.

In short, the Fisher's version of quantity theory suggests that:

1) Price level (P) is determined by quantity of cash in hand (M) average velocity of circulation of money (V) and the volume of goods and services transacted (T)
2) P does not change by itself
3) V and T being assumed constant, a change in M result in a proportionate change in P.

Fisher also provided an extended form of his original equation of quantity theory. In this form he classifies money into two groups: i) the cash held by the public; and ii) the bank depoists.

In the original equation i.e., Equation 1, presented earlier he had considered only the first variable. In his extended version he introduces a new set of variables, viz. demand deposits (M') and the velocity of circulation of demand deposits (V'). Equation 1, thus, can be modified as:

$$PT = MV + M'V' \quad \ldots\ldots (3$$

or

$$P = \frac{MV + M'V'}{T} \quad \ldots\ldots (4$$

According to Fisher, V is a short run constant and M' cannot change automatically because there is a stable relationship between the primary money, the bank reserves and the volume of bank deposits. Thus, with the help of extended version also Fisher came to the same conclusion as with his original version, i,e., the changes in quantity of money are the exclusive cause of changes in general price level.

Criticism of Cash Transactions Approach : The cash transactions approach was severely criticised by some of the later economists. The major points of criticism are presented below:

1) Fisher's version of quantity theory is based on some unrealistic assumptions. His assumption 'other things remaining unchanged' implies that V and T remain constant In reality, change in M affect V and then T. Fisher also assumes that M affects P but not vice versa. But it is easy to find instances where P has been active and has influenced M and V. In fact, all the variables in the equation are mutually interdependent. The quantity theory ignores this mutual inter-dependence and reaches the conclusion that money (M) is the cause and price (P is the effect

2) The quantity theory is static in nature. The theory may apply to a community which is living under static conditions.

3) The theory tries to establish an unrealistic direct causal relationship between money (M) and price (P) without realising the importance of other monetary factors and relative prices. The quantity theory of money over-emphasises the role of quantity of money in determining the price level.

4) It ignores not only certain monetary factors but also the non-monetary factors, like diversification of indpstry, differentiation in human wants, transport facilities, use of bank credit, etc. These are found to have a significant effect on the price level.

5) This theory assumes the existence of full employment and postulates that beyond full employment any increase in M will result in an increased P. But when there are unemployed resources, the supply curve of output would be elastic and as such the increase in-money supply (M) may lead to an increase in real income and output rather than in Price (P). However, the situation of full employment is itself highly improbable.

6) The variables P and T in Fisher's Equation lack clarity of identification. P

includes prices of all kinds of commodities and factors. They may be moving in opposite directions or some of them may not be moving at all. Similarly T includes all kinds of goods and services. How to combine these to get variables P and T seems highly difficult in practice.

7) Fisher only explains that change in M results in a change in P. But he does not explicitly specify the process by which M affects P.

8) In Fisher's version, money is needed only for transaction purposes. It ignores the fact that money is also used as a store of value and for speculative activities.

9) The equation of exchange cannot express the changes in the structure of relative prices caused by monetary factors.

10) Fisher has also failed to capture the role of rate of interest as a link between money (M) and price (P).

Inspite of all its limitations, Fisher's quantity theory of money has attracted sufficient attention of students and policy-makers alike. A number of instances can be cited from economic history to prove validity of this version of Quantity Theory. The rapid rise in prices in India in recent years is also stated to be associated with a substantial increase in the supply of money in the economy. However, it needs to be emphasized here that what quantity theory postulates is not the complete truth. So, we need to look beyond.

Check Your Progress A

1) What is quantity theory, of money ?

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2) List the assumptions of Fisher's version of quantity theory.

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3) Which of the following statements are True and which are False?

i) Exchange of money and the general price level move in the same direction.

ii) According to the quantity theory of money, the value of money depends upon the quantity of money in circulation at a given point of time in the economy.

iii) According to Fisher, the quantity of money in any economy depends upon:
   a) the quantity of cash with the public; or
   b) the velocity of circulation of the cash.

iv) All units of money do not circulate at the same rate.

v) Money is demanded only for transactions purposes.

vi) Fisher's quantity theory of money assumes that it is beyond full employment that any increase in M will result in an increased P.

3.2.2 Cash Balances Approach

Some Cambridge economists, viz. Alfred Marshall, A.C. Pigou, J.M. Keynes, and D.H. Robertson gave a different version of quantity theory of money, known as the **Cash Balances Approach or the Cambridge Version.** The earlier version of quantity theory laid emphasis on the supply side of money, while the cash balances approach emphasised the demand side of money. **According to cash balances approach the value of money depends upon the demand for money; but the demand for money arises on account of its function as a store of value.** The essence of the Cash balances approach has been clearly stated by Marshall as follows: ***'in every state of society there is some fraction of their income which people find it worthwhile to keep in the form of currency; it may be a fifth or tenth or a twentieth. . . A large command of resources in the form of currency renders their business easy, smooth and puts them at an advantage in bargaining.'***

According to Marshall people keep a certain part of their annual income and wealth in the form of 'ready purchasing power'. The aggregate demand for money, therefore, depends upon their annual income and the size of their wealth. Treating the demand for money as a stable function of income and property, Marshall expressed it in terms of the following equation :

$$M = KY + k' A \quad \ldots\ldots (5)$$

Where M stands for the quantity of money, K represents the portion of income which people want to hold in cash, k' is the portion of their assets they want to hold in cash, A is the money value of assets and Y is the total annual money income.

Those who followed Marshall, later neglected the assets part of the equation. Further in the Marshallian equation, the team Y was further decomposed into real total output (0) and the price level (P), thus giving us the equation :

$$M = k P O \quad \ldots\ldots (6)$$

$$\text{or,} \quad P = \frac{M}{k.O} \quad \ldots\ldots (7)$$

According to Marshall's equation (Equation 7), P is influenced not only by changes in M, but also by changes in k.

Marshallian cash-balance approach has been criticised because when we divide both sides of Equation *(6)* by k and replace $\frac{1}{k}$ on the left hand side by V, we again arrive at Fisher's Equation (though in its income version). But to criticise cash-balance approach on this count is to entirely miss its essence. As Friedman points out, "The two approaches stress different aspects of money, make different definitions of money seem natural, and lead to emphasis being placed on different variables and analytical techniques."

Cambridge Equation : A. C. Pigou stated the Quantity Theory somewhat differently when he put the cash balance equation in the following form :

$$P = \frac{kR}{M} \quad \ldots\ldots (8)$$

Where R is the total real income, k stands for the proportion of total real income to be maintained in legal tender, M is the total units of legal tender and P represents the value (or purchasing power) of money. But we know that all people do not hold cash strictly in the form of legal tender money. Some of them hold part of it in the form of bank deposits. Keeping this in view the above equation was suitably modified to make it applicable to those situations in which k is held partly in currency and partly in the form of bank deposits. The equation in its modified form becomes :

$$P = \frac{KR}{M}\,(c + h(1 - c)) \quad \ldots\ldots (9)$$

$$\text{or,} \quad M = \frac{KR}{P}\,(c + h\,(1 - c)) \quad \ldots\ldots (10)$$

In this equation c represents the proportion of k which the community holds in the form of actual legal tender, and h stands for the proportion of legal tender money which is kept in the form of bank deposits. D.H. Robertson gave a similar equation to that given by Pigou. According to him :

$$M = k PT \quad \ldots\ldots (11)$$

$$\text{or,} \quad P = \frac{M}{k T} \quad \ldots\ldots (12)$$

where, M represents cash with the public, P the price level, T the total amount of goods and services and k is the fraction of T for which the people wish to keep in cash. Robertson's equation is considered better than Pigou's as it is a simpler explanation of the value of money,

Criticism of Cash Baiaaces Approach

Cash balances approach suffers from the following shortcomings :

1) The introduction of the factor R (which represents the current income of

community) suggests that a change in its quantity is one of those important factors that directly influences the demand for cash reserves. This is not true.

2) According to Keynes the importance given to the proportion of bank deposits to the community's income is misleading when it is extended beyond the income &posits. However, the contention of this approach that the amount of real balances held is determined by the comparative advantages of holding resources in cash, and in alternative forms, so that a change in R will be attributable to a change in these comparative advantages, is no doubt, useful and instructive.

3) The cash balances equation does not throw light on the disturbances which occur owing to a change in the proportion in which deposits are held for different purposes, like savings, business and income.

4) The Cambridge approach ignores the speculative demand for money which is one of the most important motives for holding money.

5) This approach does not furnish an adequate monetary theory which could be used to explain and analyse the dynamic behaviour of prices in the economy.

3.2.3 Comparison of Cash Balances Approach and Cask Transactions Approach

Some economists believe that these two quantity equations are basically the same. While the Fisher's version, by incorporating V, emphasises the value of money over a period of time, the cash balances equation explains the value of money at a point of time by including the concept of the demand for cash balances, k (which is just the reciprocal of V). Robertson sums up this opinion by stating that, ***'the two equations are different observations of the same phenomenon'.***

However, these two approaches also have their points of dissimilarity. The two approaches give different interpretations to the demand for money. While cash transactions approach looks upon money as a flow, the cash balances approach looks upon money as a stock. Fisher's approach emphasises velocity of money, while Pigouvian approach stresses idle balances kept as a part of the national income.

The cash balances approach is considered superior to the cash transactions approach. By focussing attention on the cash balances which people like to hold (comparing at the margin the relative advantage of holding money as against spending or investing it), the cash balances approach highlights the subjective valuation of individuals. **According to Marshall, the chief merit of the cash balances equation is that it removes the serious complications which creep in when we establish a relationship between the velocity of money in circulation and the value of money, as has been done in the cash transactions approach.**

The cash balances approach is the forerunner of the modem liquidity preference theory which is significant for the determination of equilibrium level of income and employment in an economy, and also in explaining the limitations of monetary policy while handling cyclical phenomena in an economy.

Check Your Progress B

1) What is cash balances approach to the quantity theory of money?

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2) State superiority of Cambridge approach over Fisher's approach.

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3) Which of the following statements are True and which are False?

i) In Marshall's equation P is influenced not only by changes in M but also in K.

ii) 'V' stands for reciprocal of 'K' in the Marshallian approach.
iii) Cash balances equation is associated with Harvard economists.
iv) Proportion of total real income is held partly in legal tender and partly in bank deposits.
v) 'K' in the equation of exchange denotes the fraction of money income which people desire to keep in the form of currency.

3.3 EYNES' THEORY OF MONEY AND PRICES

As you know, the quantity theory of money states that any change in the quantity of money produces a proportionate change in the same direction in the general level of prices. In other words, the value of money is a function of supply of money, such that when the supply of money is doubled its value is halved, and ***vice versa.*** This conclusion is based on the assumption of full employment, given the aggregate output The causal relationship between the supply of money and the level of prices constitutes the core of the quantity theory of money. But this relationship is not so simple and direct as classical economists make us believe. In the classical analysis, the real and the monetary sectors of the economy were taken as completely self-contained and independent of one another. The classical economists failed to realise that changes in the aggregate money supply could not influence the general price level of the economy without first affecting the real prices because the former was merely an aggregation of the later. Any change in the general price level must necessarily be traceable to prior changes in the relative prices of goods and services. Consequently, it is necessary to relate the theory of money with the theory of relative prices in order to find out the real chain of causation between changes in the quantity of money and changes in the general price level.

Keynes criticised the classical approach which regarded money as neutral, i.e., having no influence on equilibrium of the real sector of the economy. **The classical theory of money aimed at the stationary equilibrium, while Keynes was largely concerned with developing a theory of the shifting equilibrium wherein changing views about the future also influence the present situation.** In such a world, money is important becauseit serves as a vital link between the present and the future.

In his book 'General Theory of Employment, Interest and Money', Keynes has given a new version of quantity theory of money. He has integrated the theory of prices with the general theory of value and output. **He denies any direct causal relationship between increases in the quantity of money and the rise in the level of prices so long as there are unemployed resources in the system.**

According to Keynes an increase in the quantity of money increases the amount of money available for satisfying the liquidity needs for fulfilling the speculative motive Its initial impact is to lower the rate of interest in the economy. A lowering of the rate of interest tends to increase effective demand for investment, which in turn is associated with rising income, employment and output. With the rise in income, output and employment, the prices may start rising even before the point of full employment is reached. This may happen due to four main reasons:

1) Since productive resources are not homogeneous, an increase in output will generally involve diminishing returns and increasing supply prices, even though the unit costs of all factors remain unchanged.
2) The wage rate is very likely to increase with an increase in output.
3) The prices of other factors entering into marginal costs also rise in varying proportions.
4) Since the short period supply schedules in different markets often show varying degrees of elasticity, the prices may therefore start rising even before the situation of full employment is attained.

With the increase in output, the initial emphasis is almost excl'usively on increase in employment. But, later on when the situation comes nearer the full employment stage, the emphasis shifts more towards change in prices. Once the full employment is reached, further increases in effective demand become truly inflationary in the sense that they entirely result in rising prices.

The above mentioned relation between money and level of prices clearly shows that there is no direct and proportional relationship between the quantity of money and the price level as hypothesized by the traditional quantity theory of money. Rather, this relationship is indirect and remote because a whole complex of relationships is set in motion through changes in the rate of interest. Further, a change in the rate of interest may or may not lead to a corresponding change in the investment demand. If the rate of interest is able to influence the investment demand, then through the later it also affects the levels of employment, income and output and thereby leads to changes in the cost of production and prices. Whether or not this process works itself out fully depends upon the nature of the two other main determinants of income viz., the marginal efficiency of capital and the propensity to consume. For instance, if the marginal efficiency of capital, for certain reasons, suffers a decline, a fall in the rate of interest may not lead to an increase in the volume of investment, output and employment etc., and as such the prices may not rise inspite of an increase in the quantity of money. In the same way, if the propensity to consume declines because of certain reasons, increase in the quantity of money may not be associated with increase in prices. Thus, the relationship between the quantity of money and the level of prices is a complex one ; it is established through a long chain of causation as shown in Figure 3.1.

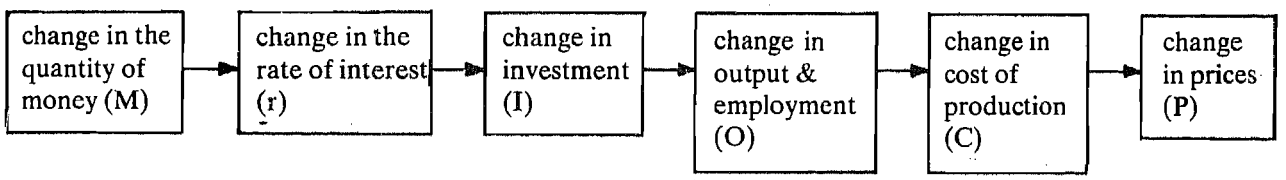

Fig. 3.1 Relationship between Quantity of Money and the Level of Prices

Criticism **of Keynesian Theory**

1) Keynesian theory is too general. It is, therefore, difficult to study actual price changes with the help of Keynesian theory. The market conditions of distribution of specific goods vary so widely, the technical conditions of production of various goods are so different, and variations in the conditions of demand affect various commodities so differently that the propositions stated in terms of total demand, total output, general technical conditions, etc., cannot be treated anything more than the very first step in a theory of prices.

2) Keynesian formulation is basically static in nature. In real world situations, production and consumption extend beyond a period. They may be a continuation of the past or a continuation into the future. And over time, their composition and, therefore, the set of relative prices would undergo a change. Being static in nature, Keynesian approach is not able to handle them.

3) Keynes holds that the level of output can be changed by changing the quantity of money which in turn depends upon the rate of interest. But this is conditioned by a long line of reasoning. No doubt, it is possible to change the level of output by changing the quantity of money stock, and the rate of interest by changing the supply of money stock, but only if other conditions of costs and revenues operate appropriately.

Superiority of Keynesian Theory

1) Keynes' theory of prices integrates the monetary theory with the theory of value, The theory of value explains that the price (which is value expressed in terms of

money) is governed by the conditions of demand and supply in the product market, which in turn are influenced by factors like marginal cost, marginal revenue and the degree of elasticity. Keynes shows that prices rise because of the rise in costs of production resulting from the inelasticity of short period supply of output and employment

2) Besides integrating the theory of value and the theory of money, Keynes also integrates the theory of output with the theory of money.

3) According to classical theorists, every increase in the supply of money leads to inflation. But to Keynes only that expansion in the money supply leads to inflation which goes beyond the level of full employment. By enabling us to distinguish between an inflationary and a non inflationary expansion of supply of money, Keynesian theory helps us to understand inflation in the right perspective.

4) One of the most important merits of Keynesian theory lies in removing the old notion that prices are directly determined by the quantity of money. Keynes brings forth the fact that the causal process whish exists between the quantity of money and prices is indirect, uncertain, complex and is brought about through changes in the rate of interest.

5) The Keynesian theory differentiates between the determination of general price level and individual prices. Individual prices of various goods are determined by their demand and supply and the type of market, while a large number of considerations enter the determination of the general price level.

3.4 MILTON FRIEDMAN'S QUANTITY THEORY OF MONEY

Keynes argued that the quantity theory, as propounded by Fisher and Cambridge economists, was too simplistic as it believed in a direct link between supply of money and price level. This led to the fall in the popularity of the ciassical version of quantity theory. In 1956, Milton Friedman edited a book entitled 'Studies in Quantity Theory of Money' which helped in the re-establishment of the quantity theory. His formulation is known as the **New or Modern Version of Quantity Theory of Money.** The setting of the modern version of quantity theory is as follows:

1) The modern theory is a theory of demand for money.

2) Like Pigou, Friedman also believes in money serving as an asset. He maintains that money is only one of the forms of wealth, the other forms being bonds, equities, physical goods and human wealth. Each of these has its distinctive features and each offers some return in money or kind. According to Friedman, the second type of demand for money is for transaction purposes (as stated in cash transactions approach also), where money serves as a medium of exchange.

3) According to Friedman, the demand for money, besides being determined by price and income levels, is also determined by the cost of holding money. **The cost of holding money consists of: a) the rate of interest on alternative forms of assets, and b) the expected rate of change in the price level.** An increase in either or both of these components will cause a fall in the amount of money which people would like to hold in cask **At higher cost of holding money, t eople will economise on their cash balances. Conversely, a decrease in the rate of interest or a fall in the price level reduces the cost of holding money,** Consequently, people will have inducement to hold larger cash balances. In short, **the demand for money and the cost of holding cash balances are inversely related.**

Given the above stated framework, Friedman defines the demand for money function as follows:

$$M = f\left(P, Y, \frac{1}{p}\frac{dp}{dt}, rb, re, w, u\right) \quad \ldots\ldots (13)$$

where

M = nominal stock of money
P = price level
Y = 'permanent' income
1. $\frac{1}{p}\frac{dp}{dt}$ = rate of return in the fonn of appreciation and depreciation in money value per rupee of real asset
rb = yield on bonds
re = yield on equity
w = ratio of non-human to human wealth
u = taste and preferences of wealth earners

Based on the specification of the demand function, Friedman argues that the factors affecting demand for cash balances can be classified into three categories :

1) The level of real income and wealth held in various kinds of assets.
2) The opportunity cost of holding cash balances.
3) The tastes and preferences of wealth holders.

On the basis of this formulation of demand for money, he concluded that demand for money being stable, it is the change in the supply of money that affects the economic activity in the society.

Friedman's application to monetary theory of the basic principle of capital theory (income is the yield of capital, and capital the present value of income) is perhaps the most important development in monetary theory since Keynesian General Theory. Its theoretical significance lies in the conceptual integration of wealth and income as influences on economic behaviour. Perhaps the most important implication of Friedman's analysis relates to the nature of the concept of 'income' relevant to monetary analysis. As stated earlier, income in his analysis corresponds to the notion of expected yield on wealth rather than as per the conventions of national income accounting.

Critical Analysis of Friedman's Theory

A major criticism of Friedman's empirical work is that the results he has got depend upon the manner in which he has defined money. His definition of money is too broad.

Although Friedman has emphasised the relationship between monetary stocks and aggregate wealth, still he has not found interest rates empirically significant as a determinant of the demand for money. Friedman's analysis reveals that the relationship between the demand for money and interest rates is weak. This weak relationship between the demand for money and interest rates results from the broad definition of money adopted by Friedman.

Check Your Progress C

1) What is Keynesian Theory of Money and Prices ?

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2) Give the restatement of quantity theory of money by Friedman.

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3) Explain the determinants of the demand for money according to Friedman.

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4) Which of the following statements are True arid'which are False.
   i) According to Keynes money is neutral hi the economy.
   ii) Keynes has denied any direct causal relationship between increases in the quantity of money and the rise in the level of prices.
   iii) Revival of quantity theory has been mainly because of the efforts of Keynes.
   iv) According to Friedman, the supply of money being stable, it is the demand for rmoney that influences economic activity.

3.5 LET US SUM UP

Frequent occurrence of wide fluctuations in the general price level has attracted special attention of the economists. Though causes for fluctuations in the price level are many, according to the quantity theorists a change in the supply of money is the main cause for changes in the level of prices.

The quantity theory of money has been stated as the equation of exchange in its various forms. Its two most well known forms of the quantity equation are.: i) the Fisher's version or the cash transactions equation, written as $MV = PT$, and ii) the cash balances equation of exchange, written as $P = KR$ or $M = KPO$ or $\frac{M}{}$ $M = KPT$, is associated with the names of Alfred Marshall, A.C. Pigou and D.H. Robertson respectively.

Fisher's cash transactions approach relates changes in the price level (P) to changes in the quantity of money (M), its velocity of circulation (V), and the volume of transactions (T). By assuming V and T as constant over time, he established a direct and proportionate relationship between the quantity of money and the price level. Criticism of Fisher's approach mostly emanates from the assumptions underlying the approach.

While Fisher's version of the quantity theory stresses the supply side of money, the cash balances approach emphasises the demand side of money. The latter approach hypothesises that for convenience a certain portion of income is kept by individual in the form of cash or liquidity. The cash balances approach, besides stressing the importance of liquidity which is significant in the determination of equilibrium income and employment, also focussed on the limitations of the monetary policy in controlling fluctuations in the economy.

Keynes while criticising the classical quantity theory of inoney has denied any direct and causal relationship between increases in the quantity of money and the rise in the price level so long as there are some unemployed resources in the economy. The relationship is rather indirect and remote, because a whole complex of relationships is set in motion through changes in the rate of interest.

Milton Friedman restated the quantity theory which is a theory of the demand for money, and not of output, money income or prices. In formulating the demand for money as a form of capital, Friedman's approach differs from the Keynesian theory. He starts with the broad concept of wealth as comprising all sources of income, including human beings. Friedman relates demand for money to the total wealth and expected future streams of money income obtainable by holding wealth in alternative forms. Friedman arrives at a demand function for money which depends on the price level, bond and equity yields, the rate of change of the price Level, income, the rate of non-human to human wealth and a taste variable.

3.6 KEY WORDS

Demand deposits: A bank deposit that can be withdrawn without notice.

Hoarding: Withdrawing money from active circulation by an individual or group, by accumulating it rather than spending it

Human Wealth: The skill and abilities possessed by individuals of a society by which it generates income.

Marginal Efficiency sf Capital: That rate of interest which reduces the net present value of a project to zero.

Monetary Policy: That part of economic policy that regulates the level of money or liquidity in the economy in order to achieve a set of economic goals like controlling inflation, correcting balance of payments, disequilibrium, etc.

Propensity to Consume: The proportion of a small increase in income which will be devoted to increased consumption expenditure.

Real Income: Income measured in terms of the real goods and services it can buy.

3.7 ANSWERS TO CHECK YOUR PROGRESS

A 3 i) False ii) True iii) False iv) True v) False vi) True

B 3 i) True ii) True iii) False iv) True v) True

C 4 i) True ii) True iii) False iv) False

3.8 TERMINAL QUESTIONS

1) Explain the Fisher's equation of exchange. How is the cash balances equation an improvement over Fisher's equation ?
2) Discuss Keynes' Theory of Money and Prices. Is it the correct explanation of changes in price level ?
3) What is quantity theory of money ? Explairi its significance in the context of understanding the factors determining the value of money ?
4) Examine how Milton Friedman restated the traditional quantity theory of money.
5) Write short notes on the following ?
   i) Cambridge Equation of Exchange.
   ii) Superiority of Keynes' analysis of Money and Prices over the classical analysis.
   iii) Basic difference between the Fisher's and Friedman's formulation of quantity theory of money.

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the university for assessment. These are for your practice only.

UNIT 4 INFLATION

Structure

4.0 OBJECTIVES

After studying this unit, you should be able to :

- explain the meaning and definition of inflation
- explain the types of inflation
- outline the concept of inflationary gap
- describe the demand-pull and cost-push inflation
- comprehend the effects of inflation
- suggest' how inflation can be controlled.

4.1 INTRODUCTION

The modem economies in general have been facing the problem of inflation more severely in recent years. These economies, therefore, concentrate on the study of specific causes of price rise and designing of policies to promote price stability. Earlier, only the underdeveloped economies of the world faced the serious problem of persistent price rise. But lately even the developed countries have fallen victim to this problem. In this unit we will discuss the meaning and nature of inflation, types of inflation, effects of inflation and various methods available to overcome this problem.

4.2 MEANING OF INFLATION

According to Pigou inflation takes place **"when money income is expanding relatively to the output of work done by the productive agents for which it is the payment".** At another place he says that **"inflation exists when money income is expanding 'more than in proportion to income earning activity".**

RC. Hawtrey associates inflation with **"the issue of too much currency".** T.E. Gregory calls it a state of **"abnormal increase in the quantity of purchasing power".** In general, inflation may be defined as a sustained rise in the general level of prices brought about by high rates of expansion in aggregrate money supply. All these

definitions have a common feature. They stress the point that inflation is a process of rising prices (and not a state of high prices) showing a state of disequilibrium between the aggregate supply and the aggregate demand at the current level of prices. In other words, prices rise due to an increase in money supply compared to the supply of goods. This is quantity theory approach to price change. However, any rise in price level should not be taken to mean inflation, as prices in a dynamic economy do rise on account of factors other than that discussed above.

Keynes does not agree with the quantity theory approach that it is the volume of money that is responsible for price rise. According to Keynes, inflation is caused by an excess of effective demand, and the state of true inflation begins only after the level of full employment, employment will change in the same proportion as the quantity of money, and when there is full employment, prices will change in the same proportion as the quantity of money. He believes that we do not unduly fear inflation because as long as there are unemployed human and material resources, an increase in the quantity of money will go to increase employment. After full employment all increases in money supply will increase the price level. Keynes does not deny that prices may rise even before full employment but such a phenomenon he called as 'semi-inflation' or 'bottlencck inflation'.

Keynes introduced a new concept called the inflationary gap. The inflationary gap shows a situation in the economy when anticipated expenditures (demand) exceed the available output (supply) at base prices or at the pre-inflation prices. Thus, the inflationary gap is measured by the difference between the disposable income on the one hand, and the output available for consumption on the other. In other words, when on account of increased investment expenditure or government expenditure or both, money income rises, but due to limitations of the capacity to produce, the supply of goods and services does not increase in the same proportion, an inflationary gap emerges, giving fillip to rise in prices. It arises only when the total money income that people are keen to spend on the consumption exceeds the total output available at pre-inflation prices.

The prices continue to rise so long as the inflationary gap exists. Look at Figure 4.1 which shows how inflationary gap arises in an eco'nomv.

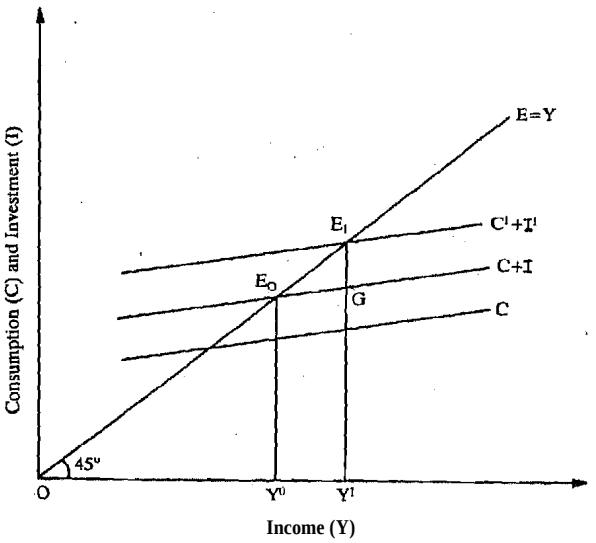

Figure 4.1 Inflationary Gap

In Figure 4.1 income is measured along horizontal axis, and consumption and investment along vertical axis. At the 45 line is a zero saving line. C is the consumption curve, while $C + I$ shows consumption plus investment expenditure at full employment level. Obviously E_0 is the point of equilibrium and, there, Y^0 becomes the full employment income.

Now suppose there is increased investment expenditure by consumers, business houses and government It will shift the C + I curve to $C^1 + I^1$. The $C^1 + I^1$ curve intersects 45° line at E_1, thus, giving an equilibrium level of money income of OY^1. However the increased expenditure does not lead to increased output because

economy was already in a state of full employment. Thus available output is smaller than the money income. This gap, which is $E_1 G$, is known as the **inflationary gap.** Keynes believed that this inflationary gap has to be lowered by reducing the excess purchasing power with the help of appropriate tax measures, or voluntary or compulsory saving by the people.

Thus, the salient features of inflation are as follows:

1) Inflation is always accompanied by rise in prices and it is, infact, uninterrupted increase in prices.

2) Inflation is essentially an economic phenomenon as it originates within the economic system and is fed by the action and interaction of economic forces.

3) Inflation is a dynamic process which can be observed more or less over a long period

4) A cyclical movement should not be confused with inflation.

5) Inflation is a monetary phenomenon as it is generally caused by excessive money supply.

6) Pure inflation start after full-employment.

4.3 TYPES OF INFLATION

Inflationary situations may be classified on the basis of different considerations. We may distinguish between different types of inflation on the basis of degree or speed with which the prices rise. The distinction may also be based on the processes through which inflation is induced. It is also possible to classify inflation on the basis of time. Sometimes inflation is sporadic, at another times it is comprehensive. Lastly, inflation may be open or suppressed.

Classification based on the Degree of Price Rise

On the basis of rapidity with which prices increase, inflation may be divided into four types: 1) creeping inflation, 2) walking inflation, 3) running inflation and 4) jumping or galloping or hyper-inflation.

Creeping inflation is the most mild form of inflation and some economists do not consider it to be dangerous for the economy. Infact, some economists consider it to be important instrument of economic development. It is argued that it keeps the national economy free from the effects of stagnation. But some economists believe that mild inflation may ultimately become hyper inflation so why not nip it in the bud.

In case of **walking inflation,** the rise in prices becomes more marked as compared with the situation obtaining under creeping inflation. In fact, it is a danger signal of the occurrence of running and jumping inflation under which the rise in prices takes place at a faster rate.

In hyper or galloping inflation, prices rise every moment and there is no limit to the height to which the prices might rise. Hyper inflation is an indication of the highest degree of abnormality in the monetary system of a country. Under the conditions of such an inflation, all assets having a fixed income lose their real value. The best examples of such assets and incomes are provided by salaries, savings, mortgages, insurance policies, bonds, etc.

Classification based on the Processes

When classified on the basis of different processes through which it is induced, we find the following kinds of inflation:

1) Deficit-induced inflation, which is caused by the adoption of deficit financing or by government spending in excess of its revenue receipts.
2) Wage-induced inflation, which results from an increase in money wages.
3) Profit-induced inflation, which occurs on account of an increase in the profits of the manufacturers.

There is also peace-time inflation which refers to the rise in prices during periods of peace resulting from increased government outlays. Sporadic inflation is of sectional

nature, occurring due to abnormal shortage of some specific goods. A typical case of sporadic inflation would be an increase in prices of food products as a result of crop failure or a rise in the prices of manufactured goods resulting from the formation of a successful monopoly which aims at the curtailment of output, or rise in the prices of those goods whose production has been interrupted and capacity curtailed by war,

Inflation may be open or suppressed. It is open when prices rise without any interruption. Suppressed inflation exists in the economy when price increases ere suppressed due to the adoption of policies of effective price control and rationing of essential goods by government

There is a vast literature on various aspects of inflation which is not possible to discuss here. We shall, therefore, discuss only the major explanations of the sources of inflation.

4.3.1 Demand-Pull Inflation

It emerges when the aggregate demand exceeds the level of full employment output. Consumers and investors seek to buy more than the total amount of output that can be produced. This type of inflation is also known as excess demand inflation. The demand-pull inflation may be caused by an increase in the quantity of money. An increase in the quantity of money would lower the rate of interest which would stimulate investment. This wil! also lead to an increase in consumption expenditure through the multiplier. The demand-pull inflation can also occur without an increase in money supply. This would occur when aggregate demand increases either because of rise in the marginal efficiency of capital or a rise in the propensity to consume.

Look at Figure 4.2 which illustrates the case of demand-pull inflation. In this figure curves marked D_1 to D_5 show aggregate demand and curve S represents the given supply. As aggregate demand curve moves higher and higher from D_1 to D_5, ,the price level rises higher and higher from P_1 to P_5. Shift of aggregate demand function from D_1 upto D_3 leads to increase both in the price and the aggregate output because the full employment level is not yet reached. This is known as bottleneck inflation. Once full employment is reached at point C, further upward shift of D will raise only the price level. This is known as true inflation.

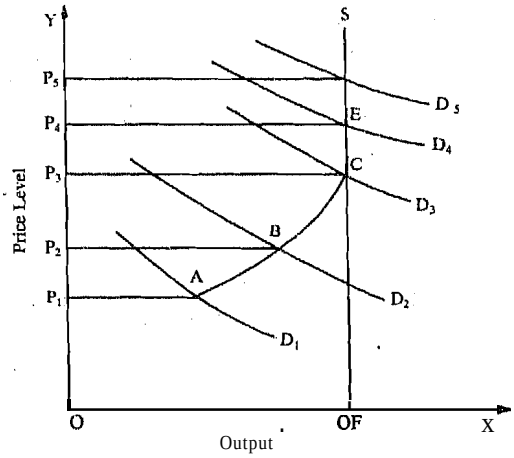

Figure 4.2 Demand Pull Inflation

4.3.2 Cost-Push Inflation

Before 1950s, inflation was largely analysed in terms of the excess demand explained either in the classical quantity theory version or in terms of Keynesian theory. The supply or cost analysis of inflation attracted attention during the 1950s. The cost-push inflation analysis, also known as the "new inflation" theory, asserts that inflation occurs due to increase in the cost or supply price of goods. It is caused mainly by three factors : i) an increase in wage rate, ii) an increase in profit margin, or iii) an increase in material costs.

For example, rapidly rising money wages were not accompanied by corresponding increase in productivity in certain key sectors of the economy, results in higher prices

in these sectors. Martin Bronfenbrenner and F.D. Holzman observed, *cost inflation has been the layman's instinctive explanation of general price increases since the dawn of the monetary system. We know of no inflationary movement that has not been blamed by some people on profiteers, speculators, hoarders, or workers and peasants living beyond their station.*

Stated in terms of the aggregate demand and aggregate supply functions, the cost-push inflation emerges in the economy due to the pressure of various factors which shift the aggregate supply function upward. Look at Figure 4.3 which illustrates cost-push inflation.

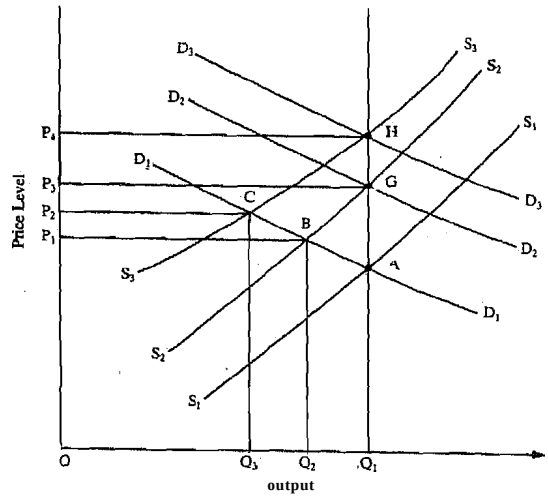

Figure 4.3 Cost-Push Inflation

Let the full employment equilibrium exist at point A where the demand curve D_1 and the supply curve S_1 intersect each other. The equilibrium output is OQ_1 and price P_1. If the aggregate supply function shifts to S_2, output declines to OQ_2 and the price level rises to P_2. When the supply function further rises to S_3, output declines to OQ_3 and price level rises to P_3. Thus rise in price and fall in output will continue so long as upward shift in the supply function continues.

As pointed out earlier, the main factors responsible for the upward shift in the aggregate supply functions are: 1) higher money wages secured by labour unions, **2)** higher profit margins secured by business firms in monopolistic or oligopolistic industries, and 3) higher prices of key raw materials for the production process of the economy. The inflation caused by these three factors is known as the wage-push inflation, the profit-push inflation, and the material-cost push inflation.

Check Your Progress A

1) What is inflation ?

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2) What is an inflationary gap ?

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3) Differentiate between demand-pull inflation and cost-push inflation.

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4) Which of the following statements are True and which are False ?
   i) In an economy if prices rise by 20% we can say that the economy suffers from very high inflation.
   ii) Inflation means only a state of higher prices.
   iii) When government spends in excess of its revenue, it is called deficit induced inflation.
   iv) Inflation occurs only when resources are already fully employed.
   v) If prices rise even before full employment, such a phenomenon is called bottleneck inflation.
   vi) creeping inflation is considered to be an important instrument of economic development.

4.4 EFFECTS OF INFLATION

Inflation is not considered bad so long as it creates additional employment to the factors of production. But it becomes bad the moment it goes out of control as Peter is robbed to pay Paul, taking no account of the sound maxim of social equity. "Inflation may be compared to a robber. It deprives the victim of some possession with the difference that robber is visible, inflation is invisible ; the robber's victim may be one or a few at a time, the victim of inflation is the whole nation ; the robber may be dragged to a court of law, inflation is legal". Inflation disrupts the economy and paves the way for social and economic upheavals, besides being highly demoralising. The entrepreneur faced with the demand for higher wages and trying to keep up with such a demand, a retired person trying to manage his living on a fixed pension, a person with fixed income meeting his needs of household expenditure by borrowing from banks and thrift societies, and the housewife struggling hard to serve food in a period of rising prices need hardly be told that inflation is a serious economic problem. The effects of inflation on different sectors of the economy and sections of the society are as follows :

1) **Effects on production :** Keynes felt that as long as there were unemployed resources in the economy a moderate or a mild dose of inflation might be in order; because this would lead to waves of optimism inducing businessmen to invest more. But this cannot go on forever because the limit is set by full employment ceiling, after which the prices start rising and moderate inflation starts assuming the nature of hyper-inflation. This will have disastrous consequences on production. It distorts the smooth functioning of price mechanism, hinders capital formation, stimulates speculative activities and hoarding, and leads to misallocation of productive resources. In short, inflation invites business to seek profits by manipulating markets rather than by efficient production.

2) **Effects on distribution :** Inflation has the effect of redistributing income because prices of all factors do not rise in the same proportion. Entrepreneurs stand to gain more than wage earners or fixed income groups. Speculators, hoarders, black marketers and smugglers gain on account of windfall profits. Changes in the value of money also result in the redistribution of wealth, partly because during inflation there is no uniform rise in prices and partly because debts are expressed in terms of money. Inflation is a kind of hidden tax, highly harmful to the poorer sections of society. Thus, poor become poorer.

3) **Debtors and Creditors :** Debtors borrow from creditors to repay with interest at some future date. Changes in the price level effect them differently at different time periods. During inflation when the prices rise (and the real value of money goes down), the debtors pay back less in real terms than what they had borrowed and thus, to that extent they are gainers. On the other hand, the creditors get less in terms of goods and services than what they had lent and lose to that extent

4) **The entrepreneurs :** When prices rise, producers, traders, speculators and

entrepreneurs gain on account of windfall profits because prices rise at a faster rate than the cost of production. Besides, there is time-lag between the price rise and the increase in cost. Moreover producers gain because the prices of their inventories (stocks) go up due to inflation. Also they, generally being borrowers of money for business purposes, stand to gain.

5) Investors: Different kinds of investors are affected diffe ently by inflation. An investor may invest in bonds and debentures which yield a fixed rate of interest or in real estate or equities (shares) whose returns (dividends) rise and fall with profits earned by the companies concerned When prices rise, the returns on equities go up on account of the rise in profits, while the bond and debenture holders gain nothing as their income remains fixed. By the same logic, holders will lose during depression, while the debenture and bond holders gain.

6) **Farmers**: Like producers in industry, farmers also gain during inflation. The prices of farm products go up faster than costs (like interest and taxes). Costs lag behind prices of the product received by the farmers. It has been observed in India that inflationary tendencies during war and post-war periods have helped farmers in paying **off** their old debts. Moreover, farmers are generally debtors and have to pay less in real terms, while the land revenue, taxes, etc., do not rise much. Thus, Farmers generally gain during periods of inflation.

7) Wage earners : Wage earners generally suffer during inflation, despite the fact that they obtain a wage rise to counter the rise in the cost of living. However, wages do not rise as much as the rise in prices of those commodities which the workers consume. Further, wages are allowed to rise much later than the rise in prices. Thus, there is a lag between the two, which works to the disadvantage of the worker. If the workers are organised, they may not suffer much during inflation but if they are unorganised (like the agricultural labourers) they may suffer more as they may not find it easy to get their wages increased.

8) Middle **class and salaried persons:** The hardest hit are the persons who receive fixed incomes, usually called the middle class. Persons who live on past savings, fixed interest or rent, pensions, salaries, etc., suffer during periods of rising prices as their incomes remain fixed. Kemmerer states that the middle class, however, which by hard work and thrift has built up a fund of saving to educate its children and to provide a livelihood in times of sickness and old age, finds itself in a desperate situation in a time of serious inflation.

9) Government: In a mixed economy, the public sector is affected by fluctuations in price level. As prices rise, the Government has to spend more on goods and services, including raw materials, for carrying through their projects. Estimates are revised and taxes are raised.

10) Public morale : Inflation results in arbitrary redistribution of wealth favouring businessmen and debtors, and hurting consumers, creditors, petty shop-keepers, small investors and fixed income earners. This lowers the public morale. The ethical standards and the public morale falls to miserably low levels during the period of hyper-inflation.

4.5 CONTROL OF INFLATION

Jnflation must be controlled lest it turns into hyper inflation. Control of inflation should involve monetary and fiscal steps aiming at reducing the level of aggregate demand so as to equate it with the full employment output in the economy. The level of investment or consumption or both may be curtailed by increasing the number and the rates of direct and indirect taxes and by raising the rate of interest The-measure for controlling inflation can be divided into three broad categories: i) monetary measures, 2) fiscal measures, and 3) direct controls and other measures.

1) **Monetary** measures : The central bank of the country can curb inflation by restricting the supply of money and credit with the help of three important measures available to it. They are bank rate policy, open market operations, and varying the reserve requirements of the member banks. Monetary measures,

however, are not very effective in underdeveloped countries which lack a well-developed and integrated money market In under-develop'ed countries, selective credit control is preferable to the general credit control. Selective credit control policy, which takes the form of issuing directives to the commercial banks prohibiting them from lending against certain commodities or reducing the total credit limits sanctioned by the banks against certain commodities or in certain regions, seeks to curb inflationary pressures in selected economic activities. Monetary policy is, however, subject to limitations and it alone cannot succeed in curbing the difficult problem of inflation. In India, Reserve Bank's dear-money policy, aiming at curtailing the excess bank credit, has not prevented prices from rising.

2) **Fiscal** measures : The limitations of monetary measures make it important to make use of fisca! measures to curb inflation. Fiscal measures refers to taxation, government spending and public borrowings. Government should try to mop up, through taxation, as much purchasing power as possible without adverse effects in incentives to enterprises and investment **A** decrease in government spending and an increase in government's' total tax revenue i.e., producing a surplus budget is an important fiscal measure which can successfully check inflationary pressures in the economy. **A** regressive tax structure combined with scaling down of unproductive spending can successfully reduce the impact of inflation in the economy. Devising a suitable tax policy directed towards restricting demand without discouraging production is another fiscal measure which can control inflation. Private savings have a strong dis-inflationary effect. The government should take measures to promote private savings. The government should avoid paying back any of its past loans during inflationary periods so as to prevent an increase in the circulation of money. Keynes suggested a programme of compulsory saving like deferred pay or forced savings to control inflation. Deferred pay implies that a part of the pay of the workers is credited to their savings account and would not be available for spending so long as the inflation lasts. Such compulsory saving schemes are expedient during wartime or during pat-war hyperinflation, but are not practicable in peace time, particularly in democratic societies.

3) **Direct** controls : Many countries have adopted direct measures to control inflation. These include price control and rationing of essential commodities. Rationing and price control, however, have not been very effective in underdeveloped countries because of lack of competent and honest machinery to administer such measures. These have often led to the disappearance of goods from the market giving scope for black marketing, bribery and corruption

Measures should be taken to expand the production of necessary goods at the expense of luxury goods because shortage of the necessary goods raises the prices much more rapidly than a shortage of luxury goods. Control of wages has often been suggested to check a wage-price spiral. During galloping inflation it may be necessary to apply a wage-profit freeze. Control of wages, and profits keeps down disposable income and, hence, the level of effective demand for goods and services. Efforts should be made to obtain as much foreign capital as possible. Investment financed by foreign capital is less inflationary. Every effort should be made to increase production. Preference should be given to investment in those projects which start yielding output at the earliest.

Inflation is easy to control in its initial stages. Beyond a stage it starts feeding on itself and the inflationary problem assumes such dimensions that it becomes very difficult to control. **A** hyperinflation for instance, can be removed only by replacing the old currency by a new currency. Inflation is a hydra-headed monster and should be fought with many weapons. Dependence on a single measure may not help much in curbing inflation.

Check Your Progress **B**

1) What is the effect of inflation on production ?

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2) State the main fiscal methods of controlling inflation.

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3) State whether the following statements are True or False.

i) In inflation fixed earners benefit at the cost of profit earners.

ii). During inflation debtors are benefited and creditors lose.

iii) During inflation poor become poorer.

iv) During inflation normally equity holders gain and bond holders lose.

v) Inflation can be controlled by restricting the supply of money and credit.

4.6 LET US SUM UP

Inflation is a situation of persistent rise in prices. Inflation exists, broadly speaking, when the quantity of money in the economy exceeds the supply of goods and services. According to Keynes true inflation sets in only after full employment.

Inflation can be classified on the basis of speed, time, process and the extent of the price rise. There are twd main types of inflation viz., demand-pull inflation and cost push inflation. Demand-pull inflation occurs when the aggregate demand exceeds the level of full employment output The demand pull inflation may be caused by an increase in the quantity of money. In case of cost-push inflation prices are pushed up by a rise in the cost of production. Cost of production can rise because of a rise in wages or cost of raw materials or simply rise in profit margins. In other words, inflationary pressures originate with supply rather than demand and spread rapidly throughout the economy.

Inflation is advantageous to the debtors, while the creditors lose. When prices rise, producers, traders and speculators stand to gain on account of windfall profits because prices rise at a faster rate than the cost of production. Inflation cannot be allowed to go unchecked and the various monetary and fiscal measures have to be adopted to control it. Since it is caused by an excess of effective demand, measures to control it imply a reduction in the total effective demand. Among the monetary measures we include higher bank rate, open market operaticn and other credit control measures, generally adopted by the central bank of a country. Fiscal measures include government spending, taxes, public borrowings, savings etc.

There are also certain important measures which include output adjustment, suitable wage policy, price control, rationing etc. These measures are, however, supplementary to gain monetary and fiscal measures.

4.7 KEY WORDS

Cost-Push Inflation: Inflation that occurs due to an increase in the cost of production, resulting from increased money wages, raw materials, prices etc..

Demand-Pull Inflation : Inflation that emerges when the aggregate demand exceeds the level of income and employment Excess demand may arise either in the public or private sector.

Hyper or Galloping Inflation: An inflationary situation when prices rise every moment and there is no limit to the height to which the prices might rise.

Inflation: Sustained rise in general level of prices brought about by high rates of expansion in aggregate money supply.

Open Inflation: An inflationary situation when prices rise without any interruption.

Suppressed Inflation: Condition in which as a result of adoption of certain policies by the government, prices are prevented from rising.

4.8 ANSWERS TO CHECK YOUR PROGRESS

A 4 i) False ii) False iii) True iv) True v) True vi) True
B 3 i) False ii) True iii) True iv) True v) True

4.9 TERMINAL QUESTIONS

1) Define the concept of inflation and explain inflationary process.
2) Explain the features of demand-pull inflation and cost-push inflation.
3) Examine the effects of inflation on production and distribution in a developing economy.
4) Why should inflation be controlled ? Explain the various measures to be adopted to control it.
5) Write short notes on the following:
   i) Inflationary gap
   ii) Classification of inflation on the basis of degrees of price rise.
   iii) Inflation and the workers

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the university for assessment. These are for your practice only.

SOME USEFUL BOOKS

Gupta, S.B. 1982, *Monetary Economics*, S. Chand & Co., New Delhi. (Chapters 1, 12)

Mishra, S.K., 1990, *Money, Income and Financial Institutions,* Pragathi Publications, Delhi. (Chapters 1, 2).

Mithani, D.M., 1990, *Money Banking International Trade and Public Finance,* Himalaya Publishing House, Delhi. (Chapters 1–10).

Sundaram, K.P.M., 1989, *Money, Income and Financial Institutions*, Sultan Chand & Sons, New Delhi. (Chapters 1–5).

UNIT 5 COMMERCIAL BANKING

Structure

5.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the evolution of banking
- describe the structure of banks
- identify the functions of commercial banks
- explain the economic significance of banking
- describe the methods of credit creation by commercial banks.

5.1 INTRODUCTION

Commercial banks play an important role in the economic development of any country. The business of a commercial bank is primarily to accept deposits and advance short-term loans. Apart from this, a commercial bank performs a number of other useful functions to the community, Every commercial bank gets its funds mainly from three sources: share capital, reserve fund and deposits from the general public. Various banking systems came into existence with the development of banking in the world. In this unit, you will learn about the evolution of banking systems, the functions of commercial banks, the economic significance of banking and the method of credit creation by commercial banks.

5.2 EVOLUTION OF BANKING

The origin of modern commercial banking is traceable to ancient times. The development of early commercial banking was closely associated with the business of money-changing in private sector. Famous temples of Delphi and Olympia of Greece served as centres of deposits and lending. Banking in ancient Rome was developed on the same pattern as that in Greece. However, banking, as a public enterprise, made its beginning around the middle of 12th century in Italy. Bank of Venice established in 1157 is supposed to be the most ancient bank in the world. Therefore, a number of private banking houses were established in North Europe with the expansion of commercial activities.

5.2.1 Evolution of Banking in England

Foundation of early banking in England may be traced to the presence of the goldsmiths. In the days of Civil War, insecurity and chaos reigned in England. In order to ensure safety of their money, people approached goldsmiths, who had good and strong rooms. Goldsmiths started issuing receipts for money received containing an undertaking to return money to depositors. Subsequently, these receipts acquired the status of bank notes.

Goldsmiths later found it safe and profitable to lend out some part of money. Since lending proved profitable, it became a regular feature. Regular accounts were maintained and pass books were also issued. In due course goldsmiths lent money to Government. This further induced them to give up their primary function and confine their business to that of a banker. The huge profits earned by the goldsmiths attracted many firms and merchants towards the banking business.

These developments received a temporary setback in 1672. Soon confidence in goldsmiths was restored. The Bank of England was established in 1694. Banks in several countries in Europe came into existence on the pattern of the banks in England, which led to the spread of modem banking system all over the world. However, the growth of joint stock commercial banks started only after the enactment of Banking Act in 1833 in England.

5.2.2 Evolution of Banking in India

Money lending developed as an occupation in India from 500 B.C. But the first modem bank was set up in 1688 in Madras. 'Agency Houses' started by the British in India paved the way for establishing joint stock banks in India. Bank of Hindustan was established in 1770 in Calcutta. General Bank of India was established in 1786. Three presidency banks viz., Bank of Calcutta (1806), Bank of Bombay (1840), Bank of Madras (1843) were established. These three banks subsequently merged together to form the Imperial Bank of India in 1921 which was nationalised in 1955 and named as the State Bank of India.

Many other banks like Allahabad Bank (1865), Punjab National Bank (1894), Bank of India (1906), Indian Bank (1907), Bank of Baroda (1909), Central Bank of India (1911) came into existence. However, Indian banking system experienced a series of crisis and as a consequence witnessed a number of bank failures. This is more so during the post World War I period. Reserve Bank of India was therefore established in 1935 to regulate and control the banking system in India.

5.3 BRIEF STRUCTURE OF BANKS

Structure of banking varies from country to country. Banking structure is determined by several factors like traditions, economic conditions, political situation, public attitude, governmental factors and topographical conditions. Different banking systems came into existence with the development of banking in the world. Important among them are branch banking, unit banking, group banking and chain banking. Let us study about them in detail.

5.3.1 Branch Banking

Branch banking refers to that banking system in which two or more banking offices are operated under single ownership and management as a single institution. Thus, the business is operated by the head office through a network of branches spread in different parts of the world. In this system, every bank has legal entity with one group of shareholders and one group of Board of Directors. Banking system in India and England fall in this category.

In India all commercial banks (like the State Bank of India, Bank of India, etc.) indulge in branch banking operations. In England, major banking business is done by the "Big Five" i.e., the Midland, the Westminster, Barclays, Lloyds and the National Provincial. These five banks have over 12,000 branches and control over 75% of the banking business in the country.

Advantages

The widespread and phenomenal growth of branch banking is due to various advantages

associated with this kind of banking system. They are:

1 **Mobilisation of savings:** Funds can be easily mobilised from the branches having surplus funds to the branches suffering from deficit of funds.

2) **Efficiency in management:** Branch banking provides greater scope for efficient management. In view of its size. experts and skilled personnel can be employed.

3) . **Large scale economies:** Branch banking enjoys the internal and external economies of scale in terms of operations like division of labour. utilisation of expert services, technological innovations, computeiisation. etc.

4) **Diversification of deposits and advances:** Branch banking provides a wider scope for the selection of diverse deposits and varied advances.

5) **Economy in reserves:** Each branch can maintain low cash reserves because funds can be moved from one branch to another.

6) **Remittance facilities:** Remittance of money from one place to another is more convenient and less costly.

7) **Uniform interest rates:** Branch banking facilitates mobility of capital and brings about uniformity in the rates of interest over a wider area.

8) **Flexibility in operations:** As branches operate in different parts of the country, it is therefore possible for branch banking to make necessary adjustments according to variations in local socio-economic conditions of different regions.

9) **Effective control by central bank:** The number of banks in the country are less in case of branch banking system. Hence the central bank of the country can easily and effectively control the commercial banking sector of the economy.

10) **Withstands depression:** Branch banking system is able to withstand adverse business conditions like depression.

Disadvantages

Branch banking system also suffers from the following disadvantages:

1) **Difficulty in management:** In view of its size of operations and spread of branches in different geographical areas, effective management becomes difficult in branch banking. Undue expansion results in mismanagement, incompetency, etc.

2) **Red tapism:** Branch banking is blamed for red tapism and abnormal delays in the disposal of urgent matters.

3) **Weaker branches:** Weaker and unhealthy branches can also survive in branch banking system. They offset the profits earned by other branches.

4) **Cut-throat competition:** Under branch banking a number of branches are opened in the same region by various banks. This results in the evils of cut-throat competition.

5) **Less personal contacts and familiarity with local conditions:** Due to their frequent ' transfers branch managers do not get the opportunity to develop personal contacts with customers and get fully conversant with local conditions.

6) **Utilisation of funds: Local** utilisation of funds may be less in branch banking in view of the easy availability of the facility for transfer of funds.

7) **Monopoly of power:** Branch banking creates some sort of monopoly power in a few hands which is detrimental to the country. For example, the five big banks in England control 75% of banking business and in India 93% of banking business is controlled by the public sector banks.

Though there are several disadvantages of branch banking system, they are overweighed by its advantages. In view of this the countries, where unit banking system was prevalent, are shifting over to the branch banking system.

5.3.2 Unit Banking

Unit banking refers to that system of banking in which banking operations are carried on through a single office rather than through a network of branches under the ,control

of a single bank. In other words, the single office is both the controlling as well as operating unit. Each banking unit is a separate company with separate entity. Each banking unit has its own capital, shareholders and Board of Directors. The area of operations and the size of bank are small under unit banking system compared to branch banking system. However, a few unit banks may have branches operating in a limited area. Thus, it is a localised banking system.

Advantages

Unit banking system has some advantages over branch banking system. These are:

1) Unit banks can serve local needs of small communities in a more effective manner as it is concerned with only a limited area of operation. Moreover, personal contacts with customers is far more easier in this system.
2) There are less possibilities of mismanagement, fraud and irregularities.
3) They are free from diseconomies of operations of more than the optimum size.
4) The possibilities of delay in operations due to red tapism are remote.
5) Funds are used only within the geographical area of operations.

Disadvantages

Unit banking system also suffers from certain disadvantages. These are:

1) In case of unit banking it is difficult to mobilise savings from one place to another.
2) Due to small size of operations economies of large scale cannot be enjoyed. Further, its size does not permit it to employ specialists.
3) Cost of establishment per bank is high in case of unit banking.
4) Due to large number of banks, control of central bank becomes less effective.
5) Unit bank is too small to overcome adverse business conditions.

In view of the disadvantages of unit banking system the systems of group banking and chain banking are developed.

5 3 3 Group Banking

Group banking consists of the ownership and operation of two or more banks directly or indirectly by a corporation. The group is organised around a key bank which in turn is controlled by a holding company.

This banking system enjoys the advantages of both branch banking and unit banking. However, it suffers from certain handicaps like less direct control over the constituents, difficulty of supervision and control and influence of failure of one member on the other.

5.3.4 Chain Banking

Chain banking is another form of group banking. It is difficult to differentiate it from group banking. **Chain banking refers to a system where two or more banks are controlled by a single person or group of persons through stock ownership or otherwise.** Thus, there is less formal arrangement than group banking. This system was developed in USA to overcome the drawbacks of unit banking system.

This banking system enjoys the advantages of both branch banking system and unit banking system.

Check Your Progress A

1) List different types of banking systems.

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2) Distinguish between branch banking system and unit banking system.

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3) Which of the following statements are True and which are False?
   i) Banking system in India falls under the category of branch banking.
   ii) Savings from the bank branches having surplus funds to those suffering from deficit funds cannot be mobilised.
   iii) Branch banking system brings about uniformity in the rates of interest over a wider area.
   iv) Unit banking system is better able to withstand adverse business conditions.
   v) Cost of establishment per bank is low in ,case of unit banking.

5.4 FUNCTIONS OF COMMERCIAL BANKS

The nature and significance of a bank can be known by the variety and magnitude of the functions it performs. It is highly difficult to define the term 'bank' as the concept itself is rapidly changing in-view of changes in socio-economic conditions, government policies, priorities etc. However, a few definitions will no doubt help in better understanding the nature of banking.

5.4.1 Definition of a Bank

According to Herber Hart " ***a banker is one who in the ordinary course of business honours cheques drawn upon him by persons from and for whom he receives money on current account"***

According to Section 5 of the Banking Regulation Act, 1949, ***"a banking company means any company which transacts the business of banking. Banking means the accepting for the purpose of lending or investment, of deposits of money from the public, payable on demand or otherwise, and withdrawable by cheque, draft or otherwise".***

This is quite a satisfactory definition of banking. Thus main functions of a bank may be divided into two categories: 1) primary functions, and 2) secondary functions.

5.4.2 Primary Functions

Initially, collection of deposits and granting advances used to be the primary functions of a commercial bank. However, in modem economies creation of credit and foreign exchange dealings are also treated as primary functions of a bank.

Collection of Deposits

The most important primary function of a commercial bank is collection of deposits. These deposits may be in the form of 1) fixed deposits, 2) savings bank deposits, 3) current deposits, and 4) recumng deposits.

1) Fixed deposits: A fixed deposit, also known as term deposit, is one where a customer keeps a specified amount with the bank for a fixed period, Fixed deposit holder gets interest on the deposit for that period. However, if he withdraws before the expiry of the stipulated period, he loses all or a major part of the interest earned on that deposit. Generally, the rate of interest on fixed deposits is the highest compared to that on other three forms of deposits.

2) Savings bank deposits: Savings bank deposits can be opened with a very small' amount. Though money in the savings account can be withdrawn at will, there are, however, certain limitations on the total number of withdrawals per week. The rate of interest on this deposit is normally higher than that of current deposit but less than fixed deposit. By mobilising small amounts from large number of individuals through savings bank deposits, banks are generally able to gather huge amount of funds.

3) Current account deposits: It is also known as demand deposit. The bank opens this account on an initial deposit of Rs. 100 but only after satisfying itself about the credit worthiness of the customer. There are no limitations on the amount of deposit and number of withdrawals. Normally no interest is paid on current deposit.

4) Recurring deposits: Another type of deposit devised recently is recurring deposits. The depositor is required to deposit a fixed amount once in every month for a specified number of years. The depositor gets the principal amount along with interest after the

expiry of that specified period. The rate of interest offered on these deposits is generally the same as that offered on fixed deposits.

Loans and Advances

Normally commercial banks grant short-term loans and advances to: 1) business and trade, 2) industry, 3) agriculture and allied activities, and 4) export and import trade. Let us understand the nature of such loans and advances.

1) **Loans to business and trade:** Commercial banks grant loans on short-term basis. Business loans are divided into (i) overdrafts, (ii) cash credits, (iii) direct loans, and (iv) bills discounted.

   i) **Overdraft** is an arrangement by which the borrower is allowed to withdraw from his account more than what is deposited in his account. It is granted against collateral security. Interest is charged on the amount overdrawn.
   ii) **Cash credit** is granted against the security of goods or personal security of one or more persons other than the principal borrower. Interest is charged only on the amount made use of by the customer under this arrangement.
   iii) **Direct loans** are granted against security of movable properties. Borrower has to pay interest on the entire amount of loan sanctioned from the date of taking the loan till the time of repayment.
   iv) If trade bills are allowed by banks for discounting, they are called **bills discounted.** Discounting of bills of exchange is the most popular method in western countries.

2) **Loans to industry:** Banks grant loans and advances to industry for its working capital requirement. They grant the loans to industry in the form of overdraft, cash credit, and direct loans.

3) **Loans to agriculture and allied activities:** Banks provide short-term credit to agriculture and its allied activities in the form of crop loans, loans for irrigation, land development, purchase of cattle, etc.

4) **Export and import trade:** Commercial banks also grant loans and advances for export and import trade. They grant direct loans, guaranteeing deferred payments, discounting bills etc. for the purpose.

5.4.3 Secondary Functions

For the convenience of customers, banks also perform a host of non-banking functions called secondary functions. These functions can be divided into two categories: (1) agency services, and (2) public utility services.

Agency Services

Various functions performed by a banker as an agent on behalf of the customer are called agency services. These agency services include: collection of cheques/drafts, payments, sale and purchase of securities, trustee, executor and attorney, and correspondence.

1) **Collections:** Commercial banks take up collection of promissory notes, cheques, bills, dividends, subscriptions, rents, etc., on behalf of their customers as agents. The bank charges *'service* charges' for rendering these services to its customers.

2) **Payments:** Banks also accept the responsibility to pay insurance premium, rents, taxes, electricity bills, etc., periodically on behalf of its customers for which they charge commission.

3) **Sale** and **purchase of securities:** Customers sometimes approach the bankers for sale and purchase of their securities. For these services the banks charge commission.

4) **Trustee, executor and attorney: Banks** also act as trustees, executors and attorneys on behalf of their customers. **As a trustee,** the banker takes care of funds of the customer. helps *in* proper management of trust. As **executor,** he carries out the desires of the deceased customer in terms of the will left by him. **As an attorney,** the banker signs transfer forms and documents on behalf of the customer.

5) **Correspondent:** Banks serve as correspondents, agents or representatives of their customers. They obtain passports, traveller tickets, etc.

All the abovementioned services are called agency services as the banks act as agents to the customers in rendering these services.

General Utility Services

In addition to agency services, commercial banks perform various services useful to the customer. These services include letters of credit, draft facilities, underwriting, guarantee for deferred payments, locker facilities, references, business and statistical information and foreign exchange dealings.

1) **Letters of credit:** Banks issue letters of credit to their customers. These are useful to traders to buy goods from foreign countries on credit.

2) **Draft facilities:** Banks issue drafts to customers and enable them to transfer funds from place to place.

3) **Underwriting: Banks underwrite** share capital and debenture capital to be raised by government, joint stock companies, etc.

4) **Guarantee for deferred payments:** Importers may not be in a position to pay for their imports immediately. Exporters may allow them to pay in future but only if the payment is guaranteed. In such cases banks may give guarantee for deferred payments.

5) **Locker facility:** Banks provide locker facility to customers to keep their valuables, such as securities, jewellery. documents etc.

6) **Referee:** Banks serve as referee to the financial standing, business reputation and responsibility of their customers.

7) **Business and** statistical **information:** Banks collect and classify information regarding possibilities of trade, commerce and industry and provide the same to their customers. Some banks also publish bulletins of information for use by the general public.

Check Your Progress B

1) What is a bank?

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2) Name two main functions of a bank.

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3) State whether the following statements are True or False.
   i) Fixed deposits cannot be withdrawn before the expiry of the stipulated period.
   ii) The rate of interest paid on savings bank account deposits is higher than that of the current account deposits.
   iii) Under current account deposits, there are no limits on the amount of deposit and on the number of withdrawals.
   iv) Commercial banks do not grant loans and advances for export and import trade.
   v) Banks act as commission agents also.
   vi) Banks also help their customers in meeting their foreign exchange requirements.

5.5 ECONOMIC SIGNIFICANCE OF BANKING

A modem bank plays a significant and crucial role in the economic development of a country. In the past bankers used to be mere dealers of money. Today, they are playing the role of a leader of economic growth. Bankers render distinct services to all types of customers. Banks not only relieve the public of great anxiety and risk of safeguarding their surplus income, but also provide facilities for savings and investment, promote banking habit among the people, discourage unprofitable locking up of community's wealth and reduce idle capital of the community. Bank in its turn supply these funds to the businessmen; industrialists and entrepreneurs who require ffinds for running and developing their business and industry. In the words of B.R. Rao, *"the tiny streamlets of capital flowing into the bank s vaults become rivers and these rivers fall into the ocean of national finances to float the vessels of commerce and drive the wheels of industry."* Banks, by their ability of

creation of credit, have placed at the disposal of the nations large sums of money. Economic significance of banks can be analysed as follows:

1) Facilitates the development of trade and industry: The multifarious growth of trade and industrial sector in the modem economy is possible only if there is timely availability of finance in required quantities. Banks provide different types of loans to encourage new entrepreneurs and give financial help to the existing industrialists to diversify and develop their industrial activity. Thus, the growth and development of industry and trade is mostly facilitated by banks.

2) Facilitating the development of agriculture sector: Agriculture plays vital role in economic development of third world countries. But the development of this sector suffered from paucity of funds. Banks help agriculture and its allied activities like poultry, fisheries, piggery, etc., by providing finances and technical consultancy.

3) Facilitating the development of service sector: Banks also provide finance for various services like transport, education, etc., thereby contributing to the strengthening of the infrastructure of the economy.

4) Contributes for the balanced growth: Banks identify the nature, the scale and the location of industries needing special care. This helps in balanced growth of the economy. Banks also identify the backward regions. By providing finances to those industrial units which contribute to the growth of these backward areas, banks help in balanced regional development as well as balanced growth of the economy as a whole.

5) Encouragement for international trade: By extending credit facilities for exports and imports and providing necessary information and data on international trade, banks encourage international flow of goods and services.

6) Social service: Banks also help in fulfilling various social needs like helping the needy and poor by introducing various schemes like self-employment, village adoption, educational assistance, slum removal programmes, etc.

7) Implementation of monetary policy: Sound economic development needs appropriate monetary policy. Well developed banking system helps the economy by implementing the monetary policy formulated by the central bank of the country.

5.6 CREATION OF CREDIT

Brief introduction of the principles of portfolio management is necessary to study the concept of creation of credit.

5.6.1 Principles of Portfolio Management

Banks have to manage their portfolio (assets and liabilities) in such a way that profits are secured to meet the expenses, liquidity is assured to meet the demands of the depositors and safety of the funds is assured in order to ensure solvency.

Liquidity

Liquidity means the ability of the banker to pay back the depositors money in cash on demand. In the words of Sayers, *"Liquidity is the word that the banker uses to describe the ability to satisfy demand for cash in exchange for deposits"*. Liquidity is necessary for maintaining public confidence and is influenced by various factors like:

1) Nature of economy, i.e., developed or developing.
2) Nature of degree of development of money market.
3) Banking habits of the people in the country/region.
4) Banking structure in the country i.e., unit banking, branch banking.
5) Nature of business conditions i.e., inflation or depression.
6) Seasonal requirements such as slack season or busy season for money need.
7) Percentage of the minimum cash reserve.
8) Demand behaviour of the depositors.

Profitability

Bank is a business unit whose objective is to earn profit in order to meet the working expenses, pay the interest on deposits and to declare dividend to owners. Hence the bank has

to invest funds in such a way that it earns maximum possible income. Profitability of the bank is influenced by various factors like involvement pattern, rate of return on investment, cost s f operation, etc.

Safety

Safety or solvency of a bank depends upon the relationship between assets and liabilities. If the value of assets is equal or greater than to that of liabilities of the bank, the bank is said to be solvent.

The three principles of portfolio management conflict with each other. The bank has to balance them for sound portfolio management.

5.6.2 Credit Creation

When a bank accepts cash and opens deposit account that deposit is called the **primary deposit**. A number of depositors deposit the money with a bank. A depositor normally does not demand the bank for the payment of his full deposit money at once. Similarly, at any point of time all the depositors do not demand the bank for repayment of their full deposit money. Hence the blinker is left with some part of the deposits for granting loans and earn profits. The banker has to keep certain percentage of the deposit as reserve to meet the demands of the depositors. This percentage of reserve is called **cash reserve ratio (CRR).**

The part of primary deposits left after meeting the requirement of cash reserve ratio are given out as loan by the bank. Normally, the sanctioned amount of the bank loan is not directly paid to the borrower but is credited to his account. Thus every bank credit creates an equivalent bank deposit. This type of deposits are called **secondary or derivative deposits.** After keeping certain percentage of this derivative deposits as cash reserve, banks grant further credit. This facility of granting credit results in creation of credit.

Creation of credit refers to the power of banks to multiply loans and advances through creating deposits. According to Newlyn credit creation refers to *"the power of commercial banks to expand secondary deposits either through the purpose of making loans or through investment in securities".*

Thus, the banks can multiply a given amount of cash (or primary deposit) to many times of credit or derivative deposits. The **ratio of total derivati deposits to the total primary deposits of a bank is called credit multiplier.**

Credit Creation by a Single Rank

Suppose a depositor deposited (i.e., primary deposit) Rs. 2,000 in Canara Bank and whose cash reserve ratio is 10%. Now Canara Bank after keeping Ks. 200 (10% of Rs. 2,000) as reserve, can grant credit of Rs. 1,800 to a person by crediting the amount to his account. The bank can again grant a loan of Rs. 1620 (after keeping Rs. 180 i.e., 10% of Rs.' 1800) to second person by crediting the amount to his account. The bank can further grant another loan to a third person of Rs. 1458 after maintaining 10% reserve i.e., Rs. 162. This process will continue until the primary deposit of Rs. 2,000 and the initial excess reserve of Rs. 1800 (i.e. excess of 10% of Rs. 2,000) lead to derivative deposit of Rs. 1800 + 1620 + 1458 + ... = Rs. 18,000. Total primary and derivative deposits will be Rs. 18,000 + 2,000 = Rs. 20,000. **Credit multiplier is the reciprocal of cash reserve ratio i.e., 1÷1/10= 10 and the credit creation (dotal derivative deposits of Rs. 18,000) is the ten times of the initial excess reserve. Thus, credit creating ability of a bank is the product of credit multiplies and excess reserve of primary deposit (i.e., 10 x Rs. 1,800 = Rs 18,000).**

Assumptions of the Credit Multiplier

1) The cash reserve ratio remains the same at all the stages of credit creation.
2) There is no leakage in the credit creation process.
3) There is a well developed banking system in the country.
4) People in the country have banking habits.
5) Credit control by the Central Bank is absent.
6) Normal business conditions are in existence in the country.

Multiple Credit Creation by Banking System

Normally there would be more than one bank and the borrower of a bank may withdraw the

money and may deposit the amount in the bank which in turn can create credit. This transfer of cash within the banking system creates primary deposits and thereby provides the facility of creation of derivative deposits. This process of creation of credit through primary and derivative deposits is called multiple credit creation by banking system.

We study the process of multiple credit creation with an example. If a depositor deposits Rs. 2,000 in Canara Bank and the cash reserve ratio is 10%, the bank can grant a loan of Rs. 1800 (Rs. 2,000 – Rs. 200) to a person by crediting the amount to his account. If that person pays the amount of Rs. 1800 to the suppliers of material by a cheque and if the suppliers of material deposit that cheque in the State Bank of India, the deposit will be primary deposit to State Bank of India. Now State Bank of India can grant a loan of Rs. 1620 after maintaining 10% cash reserve (Rs.1800 – 180) to another person. If this person pays this amount to his creditors and if they deposit the amount in Syndicate Bank, this amount of Rs. 1620 will be the primary deposit to Syndicate Bank. Syndicate Bank in its turn can grant a loan of Rs 1458 after maintaining 10% cash reserve (Rs 1620 – 162) which in turn can be deposited in another bank. Thus the credit creation or the creation of derivative deposits by the banking system will be Rs 1800 + Rs. 1620 + Rs 1458 + ... = Rs. 18,000 i.e., 10 times i.e., credit multiplier.

Limitations of Credit Creation

Conceptually either the individual banks or the banking system as a whole can create credit as discussed above. But a number of problems crop up in credit creation in practice. These problems may be viewed as the limitations of credit creation.

1) The ability of the credit creation of a bank depends upon the amount of cash. The bank can create more credit, if it has larger amounts of cash and vice versa.
2) The cash reserve ratio also affects the credit creation. The lower is the ratio, the greater is the ability to create credit.
3) The bank cannot create credit practically as discussed in the concept in view of leakages like excess reserves and currency drains.
4) The required number of reliable borrowers to avail the entire credit created by banking system may not be available.
5) Required number and nature of securities may not be available to offer to the banks as security.
6) Credit Policy of the Central bank affect the cash reserve ratio.
7) All the people in the country may not have the banking habits to the required order.
8) Business conditions of the banks like inflation, depression, etc., also affect the credit creation process.
9) All the banks may not have the same nature and extent of programmes of credit sanction and disbursement.

Check Your Progress C

1) Mention important aspects which show the economic significance of banks.

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2) State whether the following statements are True or False.
   i) Banks provide different types of loans to encourage new entrepreneurs.
   ii) Banks help in balanced growth of the economy by providing finance to those industrial units which contribute to the growth of backward areas.
   iii) Banks do not encourage international flow of goods and services,
   iv) The ability of a bank for credit creation depends upon the amount of cash availability.
   v) . The cash reserve raiio is not affected by the credit policy of the central bank.

5.7 LET US SUM UP

Structure of banking varies from country to country. It is determined by several factors. Dirferent banking systems came into existence with the development of banking in the

world. Important among them are: 1) branch banking, 2) unit banking, 3) group banking, and 4) chain banking.

The nature and significance of a bank can be known by the variety and magnitude of the functions it performs. These functions can be divided into (i) primary function and (ii) secondary function. Commercial banks are the most important source of institutional credit in the money market. The business of a commercial bank is primarily to accept deposits and advance loans.

Commercial banks have come to play a significant role in the economic development of countries. Without the evolution of commercial banking in the 18th and the 19th centuries, Industrial Revolution would not have taken place in England. It may be stated that without the development of sound commercial banking, underdeveloped countries cannot hope to join the ranks of advanced countries. This is because industrial development requires the use of capital which will not be possible without the existence of banks which provide the necessary funds.

Commercial banks manage their assets and liabilities with three considerations in mind, namely, liquidity, profitability and solvency. These three principles of portfolio management conflict with each other. But the bank must balance them for sound portfolio management.

Creation of credit is a major function of a commercial bank. When a bank advances loans, there tends to be a multiple expansion of credit in the banking system. Primary deposits serve as a basis for creating derivative deposits, that is, credit creation, and for increasing money supply. However, there are certain limitations of credit creation by the banks.

On the whole, banks play a dynamic role in the economic life of every modern state. An efficient and comprehensive banking system is a crucial factor in the developmental process. Thus, in the interest of rapid economic growth, it is necessary to reform and develop a sound banking system.

5.8 KEY WORDS

Branch **Banking:** A banking system under which two or more banking units operate under single ownership and management as a single institution.

Cash Reserve Ratio: The percentage of the deposits which the banker has to keep as liquid funds.

Chain **Ranking:** A banking system where two or more banks are controlled by a single person or group of persons through stock ownership or otherwise,

Credit Creation: The power of the banks to multiply loans and advances through creating deposits.

Credit Multiplier: The ratio of total derivative deposits to the total primary deposits of a bank.

'Group Banking: A banking system where the ownership and operation of two or more banks are held directly or indirectly by a corporation.

Liquidity: The ability of the bank to pay back the depositors money in cnsh on demand.

Overdraft: An amangement by which the borrower is allowed to withdraw from his account more than what is deposited in his account.

Primary Deposit: A deposit account opened by bank by accepting cash from the public.

Unit banking: A banking system in which banking operations art carried on through a single office.

5.9 ANSWERS TO CHECK YOUR PROGRESS

3) i) False ii) True iii) True iv) False v) True vi) True

C) 2) i) True ii) True iii) False iv) True v) False.

5.10 TERMINAL QUESTIONS

1) Compare the evolution of banking in England and India.
2) What is branch banking? Explain its advantages and disadvantages.
3) Explain the concept of 'unit banking'. What are the merits and demerits of unit banking system? Suggest measures to overcome the demerits of unit banking system.
4) Define the term 'bank'. What are the primary functions of a commercial bank?
5) Explain the secondary functions and general utility services of commercial banks.
6) Explain the contribution of commercial banks to the economic development of a country.
7) Explain the concepts creation of credit, liquidity, profitability and safety.
8) What is credit creation? Explain how banks can create credit. What arc the limitations of credit creation?

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.

UNIT 6 COMMERCIAL BANKING IN INDIA

Structure

6.0 OBJECTIVES

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

- describe the basic components of banking structure in India
- list the objectives of the State Bank of India
- state the contributions of SBI
- explain the reasons for nationalisation of banks in India
- point out the problems faced by cominercial banks in India.

6.1 INTRODUCTION

In Unit 5 you have learnt about the evolution of banking system. the functions of cominercial banks and the methods of credit creation by commercial banks. Now you will study the banking system in India. In this unit you will learn about the banking structure in India, the role of State Bank of India, nationalisation of commercial banks and the problems of commercial banks in India.

6.2 BANKING STRUCTURE IN INDIA

The structure of banking in India depends upon several factors like India's economic system, economic goals, policies and programmes, and the need for flow of finance to various sectors, like export and import sector, small scale and large scale industrial sectors, agriculture and rural economy etc.

Banking structure in India can be broadly divided into seven categories: 1) Central bank, 2) development banking, 3) commercial banking, **4)** cooperative banking, **5)** rural banking, 6) export-import banking arid 7) housing banking.

1) **Central Banking:** Reserve Bank of India is the Central Bank of the country. It performs all the functions of a central bank like note-issue, bankers' bank, clearing house and credit control. In addition, it helps the country in its economic development.

2) **Development Banking:** Development banks provide long-term finance particularly to industry. They also underwrite the capital issues of companies, invest in equity shares, preference shares, debentures, etc. The development banks in India include Industrial Finance Corporation of India, Industrial Development Bank of India, State Finance Corporations and Industrial Credit and Investment Corporation of India.

3) Commercial Banking: Commercial banks provide short-term finance lo business, trade. industry, agriculture transport sector, housing and export and import sectors. Commercial banks in India can be broadly divided into three categories: 1) public sector banks, 2) private sector banks and 3) foreign banks. Public sector banks include State Bank of India alongwith its subsidiaries and twenty nationalised banks. Private sector banks are the non-nationalised banks like Vysya Rank Ltd., the Karnataka Bank Ltd., etc. Foreign banks like Grindlays Bank, Bank of America, Bank of Tokyo, British Bank of Middle East, etc., are the branches of the commercial banks incorporated in various foreign countries.

4) Cooperative Banking: Cooperative bank is an institution established on the basis of cooperative principles and dealing in ordinary banking business. They include industrial cooperative Banks, State Cooperative Banks, District Central Cooperative Banks, Primary Cooperative Banks, etc.

5) Rural Banking: Rural banks finance all kinds of agriculture and rural activities. Regional rural banks are specialist institutions established for the purpose of providing finance exclusively to rural activities. National Bank for Agriculture and Rural Development (NABARD) is an apex bank providing finance to commercial banks and regional rural banks for the purpose of directly providing financial assistance for agriculture and other rural activities.

6) Export-Import Banking: Export-import banks provide finance exclusively for foreign trade. export-Import Bank of India was established as an apex bank to finance exporters and importers through commercial banks.

7) Housing Banking: Housing banks are those banks which provide finance for construction of houses, plots, house repairs, etc. National Housing Bank was established at apex level in the country to provide housing finance through commercial banks and other agencies.

6.3 ROLE OF STATE BANK OF INDIA

The Imperial Bank of India was instituted by the amalgamation of three presidency banks of Bombay, Calcutta and Madras in 1921.

Before the establishment of Reserve Bank of India (RBI), Imperial Bank acted as the sole banker to the government, custodian of government funds, bankers' bank, clearing house, etc. There was a change in the status and working of the Imperial Bank after the establishment of R.B.I. in 1935. It remained a commercial bank. It occupied a pivotal position in the banking industry by virtue of ils large resources, business and branches. Out of the total deposits of all the scheduled banks by the end of 1954, the share of Imperial Bank was 24.5%. It also acted as an agent to the Reserve Bank of India where the latter had no branches.

6.3.1 Establishment

The government took the historic decision of nationalising the Imperial Rank on 20th December, 1954. This decision was taken on the basis of the recommendations of the Committee on All India Rural Credit Survey appointed by the R.B.I. An important recommendation of the committee relates to the setting up of "State Bank of India as one strong, integrated, state-partnered commercial banking institution with an effective machinery of branches spread over the, whole country for stimulating banking development by providing vastly extended remittance facilities for cooperative and other banks and followed a policy which would be in effective cogsonance with the national policies adopted by Government without departing from the principle of sound business."

The government accepted the recommendation and established the State Bank of India on 1st July, 1955 by nationalising the Imperial Bank of India. The State Bank of India (subsidiary banks) Act was passed in September, 1959 and in course of time, 8 major State-associated banks were amalgamated with the main bank as its subsidiaries. They are: Bank of Saurashtra, Bank of Patiala, Bank of Bikaner, Bank of Jaipur, Bank of Rajasthan, Bank of Indore, Bank of Baroda, Bank of Mysore, the Hyderabad State Bank and the Travancore Bank.

6.3.2 Objectives

One of the main objectives of nationalising the Imperial Bank was to spread banking facilities by establishing a large network of branches all over the country; According to the State Bank of India Act. the bank had a statutory obligation to open 400 new branches in the rural, semi-urban, and unbanked areas during the first five years of its existence or such extended period as might be permitted by the Rank. In this connection, the bank created a special fund known as the **Integration and Development Fund,** which would be utilised for meeting partially the losses attributable to the additional branches established in pursuance of the Act and such other losses or expenditure as might be approved by the Central Government in consultation with the Reserve Bank of India. This fund was created with the dividends due to Reserve Bank of India, the contributions of the Reserve Bank of India and the Central Government.

The State Bank of India was expected to operate it; activities in conformity with the broad economic policies of the government. **Another important objective** of the bank was to **promote agricultural finance and to solve the problems of the** existing system of **agricultural finance.**

In addition, the bank aimed at providing special facilities for the training of the personnel ,of the bank and imparting knowledge on cooperative principles.

The SBI was also expected to help the Reserve Bank of India in its credit policies and in helping the RBI in checking any monetary disequilibrium in the money market.

6.3.3 Progress

At the time of establishment of the State Bank of India, two main responsibilities were placed on its shoulders. Firstly, the Stnte Bank had to ensure smooth transformation from profit-seeking commercial banking to a truely socially oriented institution to serve the cause of the country. Secondly, it was required to undertake developmental activities which were not normally included in the business of commercial banks. The State Bank of India made a commendable progress during the last 35 years (upto March 1990) in different spheres of the economy. It has become a pioneer in the banking industry and has emerged as a model bank to all other commercial hanks in the country. The significant achievements of SBI are discussed below:

1) **Branch Expansion:** The objective of the bank during the days of its establishment was to open 400 branches within 5 years of its establishment. The bank achieved this target well in time. Since then it has been opening its offices in rural, semi-urban, unbanked and under-banked arras. The number of branches in India increased from 466 at the end of June 1955 to 8,422 by the end of March, 1990.

2) **Deposit Mobilisation:** The State Bank of India formulated several innovative schemes of deposit mobilisation. Further, its vast branch network was an added advantage for accelerating deposit mobilisation. The bank's aggregate deposits increased from Rs. 188 crore in June 1955 to Rs. 37,666 crore by the end of October, 1990. A substantial amount of these deposits was mobilised from rural and semi-urban areas.

3) Advances: The bank's total advances at the end of 1955 were Rs. 99 crores. The total advances of State Bank of India and its associates (excluding investment in government securities) increased to Rs. 25,322 crore by October, 1990.

   The hank has become the major financial institution, providing finance for short-term and medium term for agriculture, small-scale industries; medium and large industries, weaker sections of the society, etc. Normally, commercial banks are not allowed to enter into medium term financing but RBI was allowed to provide medium-tern finance to industries. Bulk of the credit of the SBI fell to the share of industries like iron and steel, engineering, fertilisers and chemicals, and the small scale industries.

4) **Export Finance:** The bank's role in the,field of export promotion includes exporl financing, exploring and developing new markets for Indian exports (both traditional and non-traditional). The Bank maintains an information service for its customers on export possibilities of various commodities. The Bank also circulates information to Indian exporters and importers. It established the international division in Bombay in

1970. This divisicn seeks to bring together Indian exporters and foreign importers in addition to providing a wide range of information. The Bank also assists in securing foreign currency loans.

5) **Lead Bank Scheme:** Under the Scheme the State Bank of India and its associates and the 20 nationalised banks were allotted the districts and were asked to play the 'lead role'. The allotment of districts to the various banks was based on such criteria as the size of the bank, the adequacy of its resources for handling the volume of work, contiguity of districts, the regional orientation of banks, the desirability of each State to have more than one lead bank operating in the territory and, to the extent possible, for each bank to operate in more than one state. Thus, under the Scheme leading banks share the responsibility for surveying and developing the banking potential of all the districts in the country. Under the Scheme, 90 districts were allotted to the State Bank of India and its subsidiaries. The SBI has prepared detailed survey reports for almost all the districts. The bank has also taken up various studies in all the community development blocks in the lead districts allotted to it.

6) **Small-Scale Industries:** A scheme for financing small-scale industries was formulated by the State Bank of India immediately after its inception. The scope of the scheme was extended in 1960 to cover the grant of term loans for the purchase of fixed assets also. In addition, the bank decided to reach out to the prospective borrowers through a system of surveys and offer a package of credit covering the entire requirements of the borrower. In addition to the comprehensive credit facilities, the bank also liberalised the terms and conditions.

The bank also introduced the Entrepreneur Scheme in 1967. Under this scheme, importance was given to the competence of the entrepreneur and technical feasibility and economic viability of the project. The Bank also introduced the Rural Industries Project in 1969 to help small artisans. The Bank was also actively associated with the half-a-miition jobs programme sponsored by the government for the educated unemployed. The *Bank* started implementing the recommendations of its study team from 1975 on all aspects of small industry financing and aimed at improving the qualitative aspects of financing, implementing, nursing programmes, etc.

Bank assistance to small scale industries which was Rs. 10 lakh at the end of 1956 increased to Rs. 3,412 crore (including that of associate banks) by the end of March, 1990, benefiting 13.51 lakh small scale units.

7) Agricultural Finance: The Bank grants direct advances to farmers for all agricultural activities mainly on the basis of the progressivenessof the farmers and the economic viability of the schemes.

The bank introduced the Small Farmers Scheme and Farm Graduate Scheme in 1969. In the first scheme the Bank primarily insisted upon group guarantee of the small farmers without insisting upon any other security. The Farm Graduate Scheme sought to extend credit to technically-qualifiedpersonnel, particularly Graduates in Agriculture, Dairy Science, etc.

Total direct assistance of the State Bank of India group to agriculture increased from Rs. 176 crore in 1975 to Rs. 2,757 crore by June, 1986. Similarly, indirect finance provided by the banks increased from Rs. 65 crore at the end of 1975 to Rs. 511 crore by the end of June, 1986. Total advances to agriculture were to the tune of Rs. 3,168 crore by the end of March, 1990.

In 1971, the SBI decided to move away from scattered lending and to adopt intensification of the area approach. An important feature of the strategy was to select intensive centres, preferably in backward areas. Agricultural Development Branches (ADB) were set up at such centres. Upto the end of 1977 the Bank had opened 314 agricultural development branches, each providing credit to agriculturists by way of crop bans, investment loans and other needs in the area comprising about 100 villages. Finance is also provided for activities allied to agriculture like dairy and poultry, and also for the construction of godowns, transport facilities and marketing of crops, etc.

A village adoption scheme has been formulated by the State Bank. According to this scheme, a branch adopts a few villages for intensive and integrated financing of farmers for meeting the various loan requirements, irrespective of size of holding, nature of loan

requirement and size of loan. A system of group guarantees has been instituted in the case of non-viable farmers.

In addition to providing direct finance to farmers, the Bank also provides finance indirectly through primary credit societies.

Financing Land Mortgage Banks: The bank assistance to land mortgage banks is of three types:

1) subscription to the debentures issued by the Central land mortgage banks;
2) granting advances on the security of such debentures;
3) provision of interim financial accommodation to central land mortgage banks against government guarantee.

8) Small **Business Finance:** The Bank has formulated its policies for meeting the credit need of the small borrower engaged in economic activities such'as distribution, transport, etc.

9) Employment-oriented Lending: This scheme was initiated in 1971. The Bank was the first to formulate an employment oriented lending scheme to finance, on concessional terms, technically-qualified or experienced persons to set up small industrial ,units. A similar scheme was also extended to agricultural graduates. Schemes such as entrepreneur scheme, farm graduate scheme and scheme relating to agro-service centres were implemented more vigorously, in addition to devising new schemes for doctors1 dentists, engineers, graduates etc. Initially emphasis was laid on self-employment, but was subsequently modified to cover self-employment/additional employment on account of expansion and removal of under/partial employment.

10) Different Interest Rate Scheme: This scheme was introduced in August, 8972. Bank group's advances under this scheme increased from Rs. 3.9 crores to Rs. 1,361 crores during December, 1973 to March, 1990. This scheme resulted in the generation of gainful economic activities. Loan is granted on reasonable tenns and conditions under this scheme. Total beneficiaries under this scheme stood at 18.45 lakhs by the end of June, 1986.

11) Merchant Banking Division: The State Bank set up the merchant banking division in 1972, which in addition to serving the clients, helps the small and rnedium entrepreneurs who wish to set up industrial enterprises and enter the capital market for the first time. This division assists technocrats and new entrepreneurs who do not know how to make arrangements regarding financial planning, arranging capital structure, public issue, etc.

Check Your Progress A

1) State the seven categories of the banking structure in India.

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2) Fill in the blanks:
   i) After the establishment of ..... the status and working of the **Imperial Bank underwent** a basic change.
   ii) **Intergration** and Development Fund was created to help **SBI** in pursuing the **policy of** ..... expansion.
   iii) **Development** banks provide long-term finance, particularly to.....
   iv) The SBI had to ensure smooth **transformation from** profit-seeking commercial **banking to** a truly ..... oriented institution.

3) **State** whether the following **are** True or False.
   i) **SBI was** expected **to** follow policies which **conform** with the **broad** economic policies of **the** country.
   ii) **SBI** has given priority to export finance over industrial **finance.**
   iii) In spite of its best efforts SBI has not been able to significantly influence the **credit scene** in **rural India.**
   iv) **SBI** is the **only commercial** bank allowed to extend **medium** term loan.

4.4 NATIONALISATION OF COMMERCIAL BANKS

Prior to their nationalisation, Indian commercial banks neglected agricultural sector, small industry, export sector, weaker sections of the society, etc. The agricultural sector accounted for only 2.1% of the total credit in March, 1967 as against 64.3% for industry and 19.4% for commerce. Commercial banks were found falling short of meeting the social commitments and the needs of economic development.

The Government of India had, therefore, to impose social control over banks with a view to prevent monopolistic trends, concentration of economic power and misuse of economic resources. Thus the basic goal of social control was to achieve the social ends without taking over the banks into public ownership.

Consequent upon this, National Credit Control Council was set up on December 22, 1967 to assess periodically the available resources of credit and to ensure its equitable and purposeful distribution among the several sectors. This council was expected to assess the demand for bank credit, determine priority for the grant of loans, coordinate the lending and investment policies of commercial and cooperative banks. But such an arrangement was not considered satisfactory by many. Thus, opinions and arguments continued for and against nationalisation.

6.4.1 Arguments for Nationalisation

The supporters of nationdisation argued that:

- Banks in India were owned and controlled by a few big shareholders and industrialists. They influenced the pattern of allocation of bank credit.
- Banks used to grant loans only to the directors out of the deposits mobilised from the public.
- Banks used to participate in speculative activities and anti-social activities in order to maximise profits.
- Banks provided credit to big industries and completely neglected small scale industrial sector.
- Banks did not finance the agriculture and allied activities though the Indian economy was basically agricultural economy.
- Banks credit flow was not in accordance with the priorities of Five Year Plans and policies of the government.
- There was no complete safety to the depositors money.

6.4.2 Arguments Against Nationalisation

Some people criticised the nationalisation. Their arguments were as follows:

- Nationalisation of banks would result in reduction in efficiency as was the practice in other nationalised industries in the country.
- Nationalisation will generate monopolistic tendencies in banking industry, which would not be possible to control.
- There were several other ways and means to eradicate malpractices rather than nationalising the banks.
- Since nationalisation of banks was aimed at financing agriculture, weaker sections of the society etc., there would not be any security of funds of the depositors.
- Nationalisation involves huge burden in the form of paying the compensation to the shareholders.
- Nationalisation would not result in socialism but result in State Capitalism.

It was eventually felt that nationalisation was necessary for the achievement of the objectives of social control viz.,

i) Removal of control by a few.
ii) Provision of adequate credit to agriculture, small industry and exports.
iii) Giving of professional bent to bank management, and
iv) Encouragement to new class of entrepreneurs.

An ordinance was promulgated on the night of July 19, 1969, nationalising 14 leading scheduled banks each having deposits of more than Rs. 50 crore. The. 14 nationalised banks

were: Allahabad Bank, Bank of Boroda, Bank of India, Bank of Maharashtra, Canara Bank, Central Bank of India, Dena Bank, Indian Bank, Indian Overseas Bank. Punjab National Bank, Syndicate Bank, United Bank of India, United Commercial Bank and Union Bank of India.

Later the Government nationnlised six more commercial Banks on 15th April, 1980. These banks were Andhra Bank, Corporation Bank, New bank of India, Oriental Bank of Commerce, Punjab and Sind Bank, and Vijaya Bank.

6.4.3 Objectives of Bank Nationalisation

More specifically the objectives of nationalising banks in India were:

1) to mobilise savings of people to the maximum extent possible and to utilise them for productive purpose;
2) to ensure that the banking operations are guided by a larger social purpose and are subject to close public regulations;
3) to ensure that the legitimate credit needs of private sector industry and trade, big and small, are met;
4) to ensure the needs of tlie productive sector and in particular, agriculture, small scale industry, self-employed professionals are met;
5) to actively foster the growth of the new and progressive class of entrepreneurs and create fresh opportunities for hitherto neglected and backward areas in different parts of the country; and
6) to curb the use of bank credit for speculative and for other unproductive purposes.

6.5 BANKING DEVELOPMENT SINCE NATIONALISATION

Nationalisation of banks on 19th July, 1969 changed the complexion and dimensions of commercial banking in India. It helped hasten the pace of geographical and functional diversification. The new dimensions placed varying responsibilities on the shoulders of commercial banks such as expansion of bank offices in unbanked and remote rural areas on a massive scale, meeting the credit requirements of export sector, agricultural sector, small scale sector. cottage and rural industries, self-employed persons, artisans, weaker sections oi' society and small traders, etc.

1) **Branch Expansion:** The branch expansion of commercial banks is very significant in fulfilling the socio-economic goals of the country. After nationalisation, the traditional concentration of banks in and around urban centres has reduced. There is wide dispersal of branches in semi-urban, rural, backward and unbanked areas. During the 18 years of nationalisation, i.e., up to June, 1987 banks opened a record number of 53,890 branches. The number of rural branches increased from 1,832 to 30,201 during the period June, 1969 to June, 1987.

   The massive branch expansion in rural, underbanked and unbanked areas resulted in reduction in regional imbalances in banking facilities.

2) **Growth of Deposits:** Another area of bank progress is the acceleration of deposits. Consequent upon the massive efforts made by banks, deposits increased phenomenally from Rs. 4,645 crore to Rs. 1,81,260 crore during the period June, 1969 to November, 1990. The proportion of fixed deposits in the total deposits increased during this period.

3) **Credit Expansion:** There is significant improvement in the credit of banks during the post-nationalisation period. Total creclit shot up from Rs. 3,509 crore in 1969 to Rs. 1,06,603 crore in November, 1990.

4) **Growth of Farm Credit:** Commercial banks have been giving special attention to agricultural sector after nationalisation. Several measures were implemented to provide credit to agricultural sector, viz., lend bank scheme, area approach, differential interest rate scheme, village adoption scheme, financing through cooperatives, Small Farmers' Development Agency, Marginal Farmers' and Agricultural Labourers' Agency, Organisation of Farmers' Service Societies and sponsoring of regional rural banks.

   The banks provide direct finance to agriculturists in the form of short-term crop loans,

term loans for purchasing of bullocks, bullock carts, agricultural implements, digging of wells, land development etc., and also loans for allied activities like poultry, dairy, piggery, fisheries, bee-keeping etc. The percentage of credit to agriculture increased from 5.4 to 18.3 during 1969 and 1986.

5) **Finance to Small Scale Industry:** Small Scale industries have been playing a pivotal role in our economy. Commercial banks have been financing small scale industries based on the guidelines of the Reserve Bank of India which stipulate three categories of small scale industries: (a) artisan and village cottage industries, (b) small industries in the tiny sector, and (c) large size small scale units. Commercial banks financial assistance to small scale industries increased from Rs. 251 crore to Rs. 7,636 crore during the period 1969 to 1986.

6) Financing to other Priority **Sectors:** Commercial banks also provide credit to other priority sectors like self employed persons, transport operators, retail traders and small business, assistance to education, housing etc. Loans to this sector increased from Rs. 28 crore to Rs. 4,719 crore during the period June, 1967 to June, 1986.

7) Export Credit: After nationalisation, commercial banks have been providing credit to export sector on priority basis and on concessional terms and conditions. The amount of loans granted to this sector was to the tune of Rs. 2,377 crore in June, 1986.

8) Credit to Weaker Sections: The nationalised banks provide loans and advances to the people of weaker sections also. These include small and marginal farmers, landless labourers, tenant farmers and share croppers, artisans, village and cottage industries, beneficiaries of Integrated Rural Development Programme, Scheduled Castes and Scheduled Tribes and beneficiaries of differential rate of interest scheme.

Check Your **Progress** B

1) What is bank nationalisation?

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2) List out the names of the banks nationalised in India.

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3) State whether the following are True or False.
   i) Nationalisation of commercial banks has achieved its objectives.
   ii) Prior to nationalisation, commercial banks in India were generally Concerned with profit maximisation only.
   iii) Nationalisation has enhanced the efficiency of commercial banks.
   iv) Bank nationalisation in India was prompted by the necessity of credit facilities reaching the rural sector and weaker sections of the society.

4) Fill in the blanks.
   i) 14 major commercial banks in India were nationalised on July 19, ...
   ii) On April 15,1980 another ..... banks were added to the list of nationalised banks in India.
   iii) The percentage of credit to agriculture increased from ..... to ..... during 1969 and 1986.

iv) The bank expansion in rural, underbanked and unbanked areas resulted in reduction in regional ..... in banking facilities.

6.6 PROBLEMS OF COMMERCIAL BANKS IN INDIA

Though the commercial banks made significant progress in terms of branch expansion, deposit mobilisation, loans to priority sector and weaker sections of the society, they are stilt facing a number of problems in different respects.

1) Problems in Branch Expansion: Banks were asked to open their branches in rural and backward areas where minimum infrastructure facilities like roads, communication, transport, education, safe buildings for bank operations are not available. In some place there is a problem of even the security to the bank employees.

2) Problems in Deposit Mobilisation: There has been heavy competition among public sector banks in deposit mobilisation as all of them have been providing the same service. Banks also face competition in mobilising deposits from National Savings Organisation, Non-Banking Companies, Unit Trust of India, Mutual Funds etc. It is felt that despite their efforts deposit mobilisation efforts of banks have not been adequate to meet the needs of the present economic needs. It was also criticised that the schemes of deposit mobilisation of banks are not suited to the needs of the prospective depositors in rural areas.

3) Absence of Coordination: For providing finance to the same borrowers, there are several financial agencies like commercial banks, cooperative banks, regional rural banks and state financial corporation. In view of these multiple organisations and absence of coordination among these institutions it has resulted in duplicate financing, over-financing or under-financing.

4) Inadequate Finance to Agriculture: Though the commercial banks have made spectacular efforts to meet the financial needs of the agricultural sector and its allied activities, still a more vigorous effort is required as the total assistance of commercial banks to agricultural sector is not even 10% of their needs.

5) Inadequate Banking Facilities in Rural Areas: The number of banks in rural areas is quite inadequate compared to the needs of banking services, as is evident from the fact that only 5 per cent of the villages are covered by the banks.

6) Regional Imbalances: Though the commercial banks have spread their branches in different parts of the country, these are not equally distributed. According to Reserve Bank of India's Report about half of the branches concentrate in the Southern and Western regions. The states like Assam, Jammu & Kashmir, Manipur, Nagaland, Orissa, Tripura, Uttar Pradesh and West Bengal may be termed as underbanked areas.

7) Low Profitability: Financing of priority sectors, opening branches in rural as well as unbanked and backward areas, granting loans to weaker sections at low rate of interest, increase in cost of salaries and establishment and increase in overdue resulted in decline in the rate of profitability of most of the commercial banks in India. The low profitability is also caused due to increase in costs, inefficiency, bureaucratic attitude, absence of effective cost control, increase in Statutory Liquidity Ratio and Cash Reserve Ratio etc.

8) Low Efficiency: Nationalisation of banking industry has brought in all the limitations of public sector to it. These are bureaucratic attitude of the managers, absence of initiative, red-tapism, inordinate delays, lack of commitment, responsibility, indifference to work etc. These result in low efficiency of the banks.

9) Political Pressure: Nationalisation of banks has brought political interference and political pressure at all levels of the banks. The political pressure results in the poor selection of staff, granting loans and advances to undeserving, etc.

10) Problems of Liberal Credit Policy : Liberal Credit Policy which is essential to meet the credit requirements of the weaker sections, agricultural sector, etc. resulted in insecurity of bank funds and ultimately of depositors money. Liberal credit policy has also resulted in poor recovery of funds and absence of recycling of bank funds.

11) Unfair Competition : Many nationalised banks generally have their branches in the same area. Each of them, therefore, faces unfair and unnecessary competition in deposit mobilisation.

12) Problems in Financing Small Scale Industry : The basic problem associated with the financing of small industrial units is the chronic sickness of small units and consequently mounting overdues and poor recoveries.

Check Your Progress C

1) Commercial banks in the post-nationalisation period have faltered on the front of :
   i) export finance
   ii) agriculture advances
   iii) large scale industry
   iv) deposit mobilisation
   v) weaker sections of society

2) Which of the following problems are faced by commercial banks most acutely?
   i) Shortage of staff .
   ii) Safety of funds
   iii) Regional imbalances in branch distribution
   iv) Low efficiency

3) Which of the following may be stated as the objectives of bank nationalisation ?
   i) providing maximum credit facility to trade
   ii) ensuring adequate credit facilities to unbanked and underbanked areas
   iii) helping the emergence of new entrepreneurial class
   iv) satisfying customers

6.7 LET US SUM UP

Banking structure in India consists of a central bank, commercial banks, development banks, cooperative banks, export-import banks, rural banks and housing banks.

State Bank of India is the oldest, largest and premier commercial bank in India. It is primarily oriented towards social needs like branch expansion, deposit mobilisation, advances to agriculture, industry and exports, special financial schemes for rural areas, small scale industry and weaker sections of society. Though SBI has contributed significantly towards meeting these needs, yet a lot more is needed to make an impact.

In order to orient banking to the social and development needs of the country as well as to reduce the control of big industrialists, Government of India nationalised 14 leading commercial banks on July 19, 1969. To this were added 6 more banks on April 15, 1980. Nationalised banks have no doubt been able to work in the stipulated direction. There has been significant expansion in branches, deposit mobilisation and advances of these banks. Credit to small scale industry, agriculture and allied activities, rural sector and economically weaker sections has grown remarkably. However, nationalised banks have been facing problems like political pressures, opening new branches in areas devoid of any infrastructure, low profitability and efficiency and unfair competition.

6.8 KEY WORDS

Commercial Banks : Banks which provide short loans and advances.

Cooperative Banks : A banking institution established and run on cooperative principles.

Development Banks : Banks which pxovide long term and medium term credit.

Export-Import Banks : Banks which provide finance exclusively for foreign trade.

Lead Bank Scheme : The banks should adopt particular districts for intensive development;

6.9 ANSWERS TO CHECK YOUR PROGRESS

A) 1) i) Central Bank, Development banking, Commercial banking, Rural banking, Export-Import banking, Housing banking.
2) i) RBI, ii) branch, iii) industry iv) socially
3) i) True ii) False iii) True iv) True

B) 3) i) False ii) True iii) False iv) True
4) i) 1969 ii) 6 iii) 5.4; 18.3 iv) imbalances

C) 1) ii) and iii)
2) iii) and iv)
3) ii) and iii)

6.10 TERMINAL QUESTIONS

1) Explain the banking structure in India.
2) Argue for and against nationalisation of commercial banks in India.
3) What are the objectives of nationalisation of commercial banks in India.
3) Evaluate the extent of achievement of objectives of nationalisation by nationalised commercial banks in India.
5) Explain the establishment, structure and functions of the State Bank of India.
6) Evaluate the growth and achievements of the State Rank of India.
7) Explain the development of commercial banks in India.

Note : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These arc for your practice only.

UNIT 7 CENTRAL BANKING

Structure

7.0 OBJECTIVES

After reading this unit, you should be able to:

- define what a central bank is
- identify the main differences between a central bank and a commercial bank
- list the various functions performed by a central bank
- explain the effectiveness of various instruments of credit control used by a central bank.

7.1 INTRODUCTION

A central bank is the apex institution of a country's monetary and financial system. It plays a leading role in organising, running, supervising and regulating the activities of commercial banks and other financial institutions in the country. The design and conduct of monetary and credit policies are its special responsibilities. Hence, the central bank plays a very important role in the balanced development of a modem economy.

In this unit, you will study the meaning and functions of a central bank, the difference between a central bank and commercial banks, and various credit control measures used by a central bank and their effectiveness.

7.2 WHAT IS A CENTRAL BANK?

All developed and most of developing countries have a central bank. However, in most countries the central bank is a 20th century financial institution. The **Bank** of England, the oldest central bank in the world, was set up in **1694** as a joint stock company by-an Act of Parliament. The Federal Reserve **Bank** in USA was established in 1913. In India, the Reserve Bank of India was set up on April **1, 1935** under the Reserve Bank of India Act, **1934.**

The central bank occupies a pivotal position in the monetary and banking structure of every country. It is the highest monetary institution and a leader of the financial system of the country. However, it is not easy to give any precise and accurate definition of central **bank.** The definition of a central bank is largely derived from its functions. As functions of central banks vary between countries and over time, so does the definition of a central bank.

Different economists have defined central bank differently. In the opinion of W.A. Shah, ***'Central Bank is that bank which controls credit'*** whereas Hawtrey holds the view that ***'the central bank is the lender of the last resort'.*** In the statutes of the **Bank** for International Settlements, a central bank has been defined as ***'the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in the country.'*** According to Kisch and Elkin a ***central bank is 'that bank the essential duty of which is***

maintenance of stability of monetary standard,' R.P. Kent has defined it as an *'institution charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of the general public welfare.'*

It is evident from all these definitions that various economists have defined central banking by laying emphasis on its different functions like control of credit, lender of the last resort, note issue, regulation of currency and credit, and stability of the value of money in the interest of general public welfare. However, we **may conclude that central bank is that highest financial institution of a country whose main function is to regulate, coordinate,** integrate and guide *the* monetary *and* banking **structure so as to realise certain desired goals of national and public welfare.**

The banking system can work efficiently only if there is an institution at the top to direct and coordinate its activities. Failing this, the banking system would be nothing but a collection of unconnected units, each following an independent policy, often contradictory to each other. At present there is hardly any country in the world which has not set up a central bank of its own. The government seeks to influence the working and policies of the central bank directly by active participation in the formulation of broad policy framework within which the bank has to function. The government can also influence indirectly through appointment of directors, governor and other high officials of the bank.

Distinction between *a* Central Bank and *Commercial* Banks

It will, however, be useful to identify the area of activities of a central bank and to distinguish the functioning and objectives of a central bank from the commercial banks. Some of the points of difference are as follows:

1) Where the commercial banks mainly aim to earn maximum profit for its shareholders, the prime objective of a central bank is the economic interest of the nation and not profit maximisation. The central bank aims at controling the banking system and support economic policy of the government.

2) The central bank is generally an organ of the government. Its actions are, therefore, closely coordinated with those of the other departments of the government, particularly with the departments of finance, industry and foreign trade. However, unless nationalised, the commercial banks are joint stock banks which are privately owned and privately managed.

3) An important requisite of a real central bank is that it should not perform such banking transactions which are meant to be performed by commercial banks e.g., accepting deposits from general public and accommodating regular commercial customers with discounts and advances. Except under such circumstances when it becomes absolutely necessary to have direct dealing with the general public, the central bank, deals with the public only indirectly through the commercial banks and money market.

4) The central bank enjoys the monopoly power of issuing currency notes and regulating the working of the commercial banking system of the country. No such powers are vested in commercial banks; rather they operate under the supervision and within the policy framework of the central bank.

5) Generally there are a number of commercial banks, but only one central bank in a country, the USA being an exception where there is a group of 12 Federal Reserve Banks functioning as central banks.

Check Your *Progress A*

1) Indicate whether the following statements are True or False.
   i) A commercial bank is the apex banking institution.
   ii) Bank of England was set up in 1894.
   iii) Central bank is normally entrusted with the duty of regulating the volume of currency and credit in the country.
   iv) Prime objective of a central bank is profit maximisation.
   v) Central bank has the monopoly of note issue.

2) Fill in the blanks:
   i) Generally there are a number of ..... banks, but only one .....bank in the country.

ii) .....bank aims to control banking system.
iii) The design and conduct of monetary and credit policies are special responsibilities of .....bank.

7.3 FUNCTIONS OF A CENTRAL BANK

There is no unanimity about the powers and range of functions of a central bank. These have undergone a change over time and have differed between countries. However, we can broadly classify the functions of a central bank into two broad categories:

1) Traditional Functions
2) Promotional Functions

7.3.1 Traditional Functions

According to De Kock, a central bank should essentially perform the following seven functions which are now considered to be the traditional functions of a central bank.

1) Monopoly of Note Issue: The most important function of a modern central bank is that it enjoys exclusive right to issue currency notes. This function is so important that until the beginning of 20th century the central bank was known as the bank of issue. In the early days of banking, even commercial banks had the right to issue notes. But later on this practice was done away, and the power of issuing currency notes is entrusted to the central bank for the following reasons:
   i) It brings about uniformity in note issue, which is so important for the development of trade and industry.
   ii) It ensures reasonable supply of money in the economy and avoids any possibility of over-issue by individual banks.
   iii) It tends to render its control over the unwarranted credit expansion by the commercial banks.
   iv) It ensures better elasticity in note issue. It is because there may be careless expansion of money supply by commercial banks. Even the government may be tempted to increase its revenue by over-issue of currency notes which may lead to inflation in the economy.

   Hence, for the sake of uniformity, safety and elasticity, it is necessary that central bank should enjoy the monopoly of note-issue.

2) Banker, Agent and Financial Adviser to the State: The central bank functions as the custodian of govemment funds. As a banker of the govemment, the central bank accepts deposits on behalf of the government, and maintains banking accounts of both the government departments and government enterprises. It advances short-term loans to the government in anticipation of collection of taxes or raising of loans from the public. It also makes extraordinary advances during depression, war or any other national emergencies. As an agent of the government, it conducts transactions on behalf of the government involving the purchases or sales of foreign currencies, management of national debt, and also sale and purchase of government securities in the open market. In the role of financial adviser, central bank gives much sought-after advice to the government on important matters relating to economic policy. The RBI, for instance, has been advising the government of India on various economic policy matters like the stability of prices, funding of national debt, amount of deficit financing, etc., during the last two decades.

3) Bankers' Bank: The central bank functions as a banker to commercial banks. All commercial banks are required to keep certain percentage of their cash reserves with the central bank, by custom or by law. In fact, such an arrangement is useful for the banking system for a variety of reasons. Firstly, it enables the central bank to provide additional funds to such member banks which are in temporary financial difficulty. Secondly, it forms the basis for highly liquid and more elastic credit structure. Thirdly, it helps central banks to have an effective control over the credit creation by commercial banks. Fourthly, it ensures high degree of public confidence in the banking system and accords prestige to the currency notes issued by the central bank. Lastly, it helps in optimum utilisation of funds during periods of seasonal strain and in financial crises or general emergencies.

4) **Custodian of Gold and** Foreign Currency Reserves: **Today,** most of the **central banks all** over **the** world function as the **custodians** of nation's gold and foreign exchange **reserves.** Even **before** World War **II,** the central **banks** were required to keep gold and foreign exchange **reserves** for issuing **paper currency which used** to **be** convertible in **those days. This right** of central **bank** enables it to exercise a reasonable control **over** key **foreign currency, reserves** which is **very** vital to maintain the country's international **liquidity position** at a safe margin. Besides, it also helps the central Rank to stabilise the **external value of** home currency **against** foreign currencies. The **central** bank may buy its home **currency** in the foreign **exchange market** when its value is declining, and vice verso. The **possession** of gold and foreign exchange reserves also gives tremendous strength to a country in international financial dealings as gold is **an** internationally accepted medium of payment.

5) **Controller of *Credit:*** Controlling the credit operations of commercial banks has **become probably** the most **important** function of central bank in modem times. **This** is due to **the** fact that credit has **become** even **more important** than money, though money is the basis of entire credit system. Underlining the significance of control of credit by the central bank, M.W. De **Kock** has stated *that it is through this function that all other functions of the central bank are united and made to serve a conimon purpose.* *W.A.* **Shaw** considers control of credit to be *the primary function of a central bank as expansion or contraction of credit result in inflationary or deflationary conditions in the economy.* **These unwarranted** fluctuations in the volume of credit create wide fluctuations in **the purchasing** power of money and thereby cause great social **and** economic upheavals. It is, thus, **of** great **importance** that there should **be some** authority to control **and** regulate the credit creation activity **of** cotnmercial banks.

6) Bank of **Central** Clearance, ***Settlements* and** Transfer: The clearing function is **now**-a-days **regarded** as a necessary function of a central bank. As the central bank keeps cash **balances** of all commercial banks, it is quite **easy** for member banks to adjust their claims against each other in the books of central bank. This function of clearance, settlements, transfer of **mutual claims** was first evolved by **Bank** of England in 1854 **which** in course of **time** became an accepted normal function of a central bank **all** over the world. Since **commercial** banks keep their surplus funds as deposits with the central bank, it is far easier lo effect clearance and settlement of claims **between** them by making transfer entries in their books of accounts maintained with **the** central **bank.** If each bank were to enter into **separate** clearance and **settlement** transaction with **other banks** individually, it **becomes** difficult and laborious. Moreover, such an arrangement **economises** the use of money and the convenience **that** is experienced in the individual system of clearance **and** settlement.

7) **Lender of** the East Resort: Being the apex **bank** of the economy, central bank has to function as the lender of **the** last resort. This implies **that** the central bank assumes the responsibility of **meeting** directly or indirectly all reasonable demands of commercial banks for funds in times of difficulty anti financial crisis. The importance of central bank's function as the lender of **the** last resort was stressed by Walter Bagehot in **1873** in his **book** 'Lombard Street' wherein he drew the attention of the **Bank** of England to **accommodate** any eligible borrower in times of **crisis.** In the absence of this facility, the commercial banks will have to carry **substantial** cash reserves with them to meet such emergencies.

7.3.2 Promotional Functions

Apart from the traditional functions discussed **above,** the central bank also performs a number of developmental and promotional functions. The scope-of **central** bank's functions has widened during the Post-Second World War era and specially in the less developed countries where fast economic development has acquired urgency and high priority. Hence, in a developing economy like ours, the central bank assumes the responsibility of maintaining economic stability and assisting growth **process** in the following manner:

1) **It** helps to create and develop **specialised** institutions of agricultural finance in the country. In India, the RBI has helped in the creation of cooperative societies and agricultural cooperative banks by subscribing to their share capital so that fanners get timely financial help at reasonable rates of interest.

2) In order to ensure adequate supply of funds to industries, the central banks of some of

the developing countries have actively participated in setting up specialised institutions of industrial finance. Besides, it has also ensured that the small and tiny industries and the exporters are able to secure sufficient credit facilities at a relatively low rates of interest.

3) In addition to supervision and regulation of banking institutions, the central banks in developing countries have undertaken the responsibility of expansion of banking facilities, specially in rural and semi-urban areas which is so vital for balanced regional growth of the economy.

4) Promotion of well-organised and well integrated institutions and agencies of money market and capital market has become an important function of central bank in a developing economy. Thus, the central bank tries to remove institutional gaps in the money market and capital market which hinder the process of economic growth.

5) Above dl, the central bank undertakes the function of collection, compilation and publication of statistical data relating to the banking and financial sectors of the economy to highlight trends in the money market and capital market. This helps the state to take suitable economic decisions to tackle specific situations like controlling prices of essential goods, Mack money, etc.

Check Your Progress B

1) What are the seven traditional functions of a central bank?

.....

.....

.....

.....

2) State whether the following statements are True or False.
   i) The power of issuing currency notes lies only with the central bank of the country.
   ii) Central bank is the department of government.
   iii) All functions of a central bank are united through the function of credit control.
   iv) Central bank also has the promotional role of expanding banking in rural and semi-urban areas.

7.4 ROLE OF A CENTRAL BANK AS A CONTROLLER OF MONEY SUPPLY AND CREDIT

Central bank of a country takes care of the money supply and bank credit in an economy. While doing so, it tries to ensure that the total supply of money and bank credit, at any point of time, is in the best interest of the economy. In planned economies central banks have to develop such monetary policies which coordinate well with the overall plan framework and targets. Emergence of the system of managed paper currency in present day economies puts added responsibility on central banks of using restraint while issuing additional currency. The role of central bank in managing money supply and credit in the economy assumes further importance when the economies suffer from strong inflationary tendencies. In fact, the central bank often tries to reconcile several competing goals. For example, for the smooth functioning of economic activities and their expansion, it is necessary that there is growth in money supply and credit. But at the same time such growth must not lead to inflationary tendencies in the economy. Further, the monetary policies followed by the, central bank are to be formulated in such a way that they help in accelerating economic growth without adversely affecting distributive justice.

For achieving its diverse goals, a central bank may use various instruments to control money supply and credit. You will know about them later in this unit.

7.5 CONTROL OF CREDIT

There are several measures which a central bank may adopt to control the volume of money supply and credit in the economy. Broadly, these methods can be divided into two categories:

1) The quantitative methods or general instruments of credit control.
2) The qualitative methods, also known as selective credit controls.

While the quantitative controls relate to control of volume and cost of bank credit in general without regard to the field of economic activity in which credit will be used, the selective controls (qualitative methods) aim at affecting both the volume and cost of credit as well as the purpose for which credit is being offered by commercial banks.

7.5.1 Quantitative Methods

Under this category, there are four distinctive methods: 1) bank rate policy, 2) open market operations, 3) variable legal cash reserve ratio, and 4) secondary reserve requirements.

Bank Rate Policy

Bank rate refers to the rate of interest at which central bank rediscounts the eligible securities of member banks when they approach the central bank for accommodation so as to augment their liquid funds. They need these funds to expand credit facilities to their clients, specially during busy season. That is why bank rate is also called as **rediscount rate.** The bank rate policy is based on the following assumptions:

1) The lending rates of commercial banks are closely related to the bank rate. The businessmen will borrow and invest less when banks increase their lending rates due to increase in bank rate.
2) The banks keep only the minimum cash reserves with them and, hence, they have to approach the central bank for their additional cash requirements as and when need arises.
3) The banks possess eligible securities in sufficient quantities.
4) Prices, employment, wages and production are all flexible such that they will expand or contract according to changes in borrowing and investments of industrial and business houses.

Working of the Bank Rate Policy: The central bank controls the volume of credit indirectly by causing appropriate changes in the bank rate and thereby influence the lending rates of interest of the commercial banks. When there is inflationary condition in the economy, it reflects a state of excessive credit creation. To control inflation, the central bank, therefore, raises the bank rate. Increase in bank rate results in an increase in the lending rates of commercial banks. A hike in cost of bank loans will dissuade borrowers to seek more loans which will put a check on excessive credit creation by commercial banks. On the other hand, businessmen may liquidate some of their stock of goods to repay their loans. This will augment supply of goods in the market and help to check the rising trend of prices. When confronted by a deflationary situation, the central bank reduces the bank rate and thereby make borrowing cheaper so as to stimulate investments. However, the bank rate policy has lost much of its importance in recent years. The bank rate policy may become less effective when:

1) Commercial banks may have enough cash reserves and hence there is no need for them to approach central bank for additional cash.
2) It is possible that bank can raise funds from other sources and do not feel the qecessity to approach central bank for accommodation.
3) Commercial banks may not have enough approved first class bills and securities to get them rediscounted by the central bank.
4) In less developed countries where a large unorganised sector exists, lending rates of interest may not rise with increase in bank rate.
5) When profitability of investments is very high due to inflationary conditions in the economy, a bank rate hike will increase only cost of borrowing and may not affect demand for funds for investments. For example, in India, there has been a continuous rise in demand for bank credit id spite of rise in rates of interest.

Bank rate policy is considered to be an indirect method *to* control credit and for its success it is necessary that either the assumptions, on which it is based hold good or it should be used along with some other tools of credit control like open market operations.

Open Market Operations

Open market operations imply direct and deliberate buying and selling of securities and bills in the money market by the central bank to control tbe volume of credit.

Working of the Open Market Operations: When there are inflationary conditions in the economy, the central bank sells securities in the open market. This reduces the cash reserves of banks directly to the extent that they buy these securities. Besides, this also reduces the amount of customers' deposits with commercial banks to the extent that these customers acquire the securities sold by the central bank. Hence the sale of securities in the open market by the central bank reduces the credit creating base of the commercial banks and thus lead to contraction of credit and reduction in supply of money in circulation. This helps in controlling the rising demand for goods and services, thereby controlling rising trend in their prices. Conversely, the central bank purchases securities to augment cash reserves of commercial banks to increase volume of credit to combat deflation.

This method of credit control is considered to be superior to bank rate policy as it affects credit-creating capacity of banks directly by reducing their cash resewes. However, even this method has certain limitations which make this tool, at times, less effective. They are:

1) Open market operations succeed only when there is a broad, strong and active securities market. However, in less developed countries like India, there may be lack of such a market which render this policy ineffective.
2) The sale of securities may nc adversely affect liquidity of commercial banks as they may replenish the reserves by rediscounting facilities offered by the central bank.
3) Open market operations may not prove to be effective in controlling deflation. It is because even when central bank pumps more money into circulation by purchase of securities in the open market, it cannot force borrowers to borrow and invest more during deflation because prices fall and investments result in losses.

In view of these limitations, this weapon is generally used as a supplement to the bank rate policy. Therefore, both these methods are termed as complementary to each other for effective control of credit.

Variable Legal Cash Reserve Ratio

The variable cash reserve ratio is a comparatively new method of credit control by central banks. It was adopted for the first time by Federal Reserve System of USA. In countries where the money market is unorganised or underdeveloped, this method of credit control is resorted to most frequently.

At present every commercial bank is required, either by law or by custom, to keep a certain percentage of its total deposit liabilities with the central bank in the form of minimum legal cash reserves. Variation in this reserve ratio is likely to change the extent of liquidity with the commercial banks and consequently their lending powers. When credit contraction is desired, the central bank raises the cash reserve ratio, and when credit expansion is required it lowers the ratio. This method is more direct and has immediate effect on the volume of credit created by commercial banks. Cash creating capacity of the bank is calculated with the help of the following formula:

$$\Delta D = C \times \frac{1}{r}$$

where

ΔD = Change in total deposits
C = Cash deposits
r = Minimum cash reserve ratio

For examples, when cash reserve requirement is 10% and the banks have a total of Rs. 100 crore worth of cash deposits, their capacity to grant loans will be ten fold, i.e.,

$$AD = 100 \times \frac{1}{10/100} = \text{Rs. } 1{,}000 \text{ crore.}$$

However, this credit creating capacity of banks will come down only to 5 times of Rs. 100 crore (i.e., Rs. 500 crore) if cash reserve ratio is increased to 20 per cent.

However, in spite of being a powerful tool to control credit, this method suffers from the following limitations:

I) It cannot be used very frequently as it creates a lot of uncertainty for the commercial banks.

2) It generates a depressing effect on the security market and thereby hampers the process of economic development by adversely affecting investment.

3) It is discriminatory in nature as it does not apply to non-banking financial intermediaries.

4) It may prove ineffective if the banks already have excess reserves.

5) A variation in minimum cash reserve ratio has to be only marginal as any large change in this ratio will create a lot of problems for commercial banks to make quick adjustments.

Secondary Reserve Requirements

The central banks are now empowered to fix for commercial banks not only a minimum cash reserve ratio but also a proportion of liquid assets to total assets. This further limits their capacity to create credit. The underlying idea is that commercial banks should not be given liberty to convert government securities and other liquid assets into business loans and advances. A higher secondary reserve requirement will mean less loans and advances for longer periods which prove inflationary. This weapon has been used by many countries including India to tight inflation by curbing the lending capacity of commercial banks. De Kock believes that this weapon can be made to play a valuable role in containing conditions of exceptional inflationary pressures. Normally, this method sf credit control is used along with variations in minimum cash reserve ratio so as to make it more effective.

The above discussion of general instruments of credit control bring out three facts. Firstly, no single method of credit control can prove to be really effective unless it is supplemented by some other method. Secondly, these methods may prove useful to control inflation but none of them is really a potent method to control deflation. Lastly, these methods fail to give favourable treatment to priority segments of the economy whose needs for bank credit are more urgent and socially desirable.

7.5.2 Qualitative Methods

Qualitative methods of credit control are also termed as selective instruments of credit control. Selective credit controls are considered to be superior to the general instruments of credit control as they are directed not only to control total volume of credit but also the specific uses for which credit is granted. In fact, selective controls draw a distinction between desirable and essential uses and undesirable and non-essential uses for which credit is granted. Its object is to diversify the flow of credit from undesirable uses to more important, desirable and productive uses. Selective controls include the following measures:

1) Variation in Margin Requirements: The practice of margin requirement is adopted by banks to determine the loan value of a collateral security offered by the borrowers. The loan value of the security equals the market value of security minus the margin. For example, the loan value of an equity share having market value of Rs. 125, at 20 per cent margin requirement is Rs. 125 – Rs. 25 = Rs. 100. Hence bank cannot offer loan more than Rs. 100 against this security.

   The cental bank is empowered to fix the margin for various types of collateral securities and thus influence the maximum limit of the loan. An increase in margin requirement will reduce the amount of loan which can be granted against a security. This will limit the quantum of credit and help combat inflation. Variation in margin requirement is a very effective device to regulate credit in speculative spheres without, at the same time, limiting availability of credit in other productive and socially desirable fields. Besides, this method is easy to administer effectively if the central bank can enlist the cooperation of commercial banks.

2) Regulation of Consumer Credit: This method of credit control was first used in America during World War 11 to restrict consumer demand for goods which were in short supply. Regulation of consumer credit has significance in those societies where there exists a system of large scale consumer credit through instalment—payments and hire-purchase. This method implies fixation of minimum amount of down-payment and the number of instalments in which loan is repayable. The central bank regulates consumer credit by fixing a maximum limit for the loan which can be granted by commercial banks to consumers of listed durable goods. For restraining consumer , credit during inflation, the central bank instructs to increase the amount of down payment and decrease the number of instalments to restrict demand for goods and

thereby control prices. However, in less developed nations where system of hire-purchase is not yet so popular, it has only limited scope in monetary management of the economy.

3) Rationing of Credit: This method plays a very significant role in diverting financial resources into the channels fixed by the planning authorities. Rationing of credit is a method by which the central bank seeks to fix ceiling of loans and advances and also in certain cases, fix limit for specific categories of loans and advances. In this way it tries to restrict credit in the non-priority segments so as to divert availability of credit in the desired sectors of the economy. This method, however, is often not liked by member banks as it tries to curtail the freedom and initiative of commercial banks.

4) Issue of Directives: In recent years central banks have started issuing directives to commercial banks to seek their help and cooperation in effective implementation of its monetary policy. Directives may be in the form of oral or written statements, appeals and warnings, particularly to curb individual credit structures and restrain total volume of loans. The success of directives depends on the extent of willingness of banks to cooperate with the central bank. Though flouting of directives is not punishable, yet commercial banks cooperate with central bank as the former depends heavily on the later for its smooth functioning. Directives are usually supplemented by some other tools of credit control.

5) Moral Suasion: It implies persuasion and request made by the central bank to commercial banks to follow the general monetary policy of the country. In a period of inflationary pressures, commercial banks may be persuaded to curb loan facilities for financing speculative and non-essential activities. During deflationary periods banks may be requested to expand their loans and advances even against inferior securities which they normally do not accept, This method involves only putting moral pressure on commercial banks to seek their cooperation as it does not carry any threat or legal sanction. However, in India moral suasion has been used successfully and effectively by the RBI. The Bank of England has also used this method with a fair degree of success in UK.

6) Direct Action: It refers to the penal action which a central bank may take against emng bank in any of the following forms:

   i) Central bank may charge penal rate of interest, over and above the bank rate, for credit demanded by a commercial bank beyond a prescribed limit.
   i) The central bank may refuse rediscounting facilities to those commercial banks whose credit policy is not in line with its general monetary policy.
   iii) The commercial banks whose borrowings are found to be in excess of their capital and cash reserves may be refused further credit facilities by the central bank.

   However, in practice it may not be easier for central bank to initiate action against any commercial bank as it is not always easy to ascertain non-essential and unproductive uses of credit. Besides, it is also difficult to ensure that a loan given for productive purposes has not been diverted to any speculative or non-essential use.

7) Publicity: The central banks in modem times try to bring psychological and moral pressures on banking system by giving publicity to unhealthy practices in the credit system and also what should be the right policy of the banks. The central bank regularly publishes statements of assets and liabilities of banking system, review of credit and business conditions and trends in the money market to help member banks to know what they ought to do.

Limitations of Selective Credit Controls

Selective credit controls also may not prove very effective to control credit and direct it to desired channels due to the following limitations in the credit system.

1) Success of selective controls is limited as these measures do not affect non-banking financial institutions.
2) It may not be possible to ensure that the loans advanced by the commercial banks are actually spent for the purposes for which they are granted.
3) In a limited way commercial banks guided by profit motive may grant loans for forbidden purposes and then make entries in their books of accounts under different headings to escape any penal action.

Hence we can conclude that success and effectiveness of monetary policy of central bank to a great extent depends on the degree of respect if command and the willingness of the commercial banks to extend full cooperation in the realisation of national economic objectives.

Check Your Progress C

1) Which of the following is a measure of selective credit control?
   i) Bank rate policy
   ii) Moral suasion
   iii) Statutory cash reserve ratio
   iv) Open market operations

2) When credit expansion is desired, a central bank should:
   i) Buy government securities in the open market
   ii) Raise bank rate
   iii) Fix higher margin requirements
   iv) Increase secondary liquidity ratio

3) Which of the following is not an objective of credit control:
   i) Economic growth
   ii) Economic welfare
   iii) Stability of prices
   iv) Stability of foreign exchange rate

4) Indicate whether the following statements are True or False.
   i) Moral suasion has generally proved to be very effective instrument of credit control.
   ii) Bank rate policy is the suitable measure to check inflation.
   iii) Increase in minimum cash reserve ratio will have immediate effect to curb expansion of credit and thereby help control inflation.
   iv) Open market operations are more effective than bank rate policy as the bank rate policy operates only 'indirectly'.
   v) In underdeveloped economies, it will be proper to rely on any one measure of credit control for effective monetary management.

5) Fill in the blanks:
   i) To expand consumer credit the banks will ..... number of instalments for repayment of loans.
   ii) To check ..... the central bank will resort to liberalisation of credit.

7.6 LET US SUM UP

The definition of a central bank is derived from the functions which it is supposed to perform. A central bank is an apex institution of a country's monetary and financial system which plays a leading role in organising, supervising, regulating and guiding the activities of commercial banks and other financial institutions. The central bank is in close touch with the government for effective implementation of the country's economic policy and helps in realising rapid economic growth with stability of internal prices and foreign exchange rate to maintain the economy in good health.

The broad policy framework of the monetary management is devised by the government in consultation with the central bank which is to be implemented by the latter. Besides, the Governor and other high officials of the central bank are also appointed by the government.

The central bank may be distinguished from commercial banks in respect of their objectives and the area of functioning. The commercial banks act as a link between the public and the central bank and aim at profits whereas the central bank's prime objective is national economic welfare. Further, the central bank has the monopoly of note issue, apart from being the leader of the entire monetary system.

Traditionally, a central bank performs seven important functions. It acts as bank of note issue and the lender of the last resort. It functions not only as government's banker and adviser but also as a banker to all the commercial banks. Besides, it acts as custodian of nation's gold and foreign exchange reserves. Above all, it controls volume of credit in the economy. However, in recent years, the central banks of developing counties have taken

upon themselves the responsibility of helping in the promotion of such sectors as agriculture, industry and foreign trade for rapid economic development.

The most challenging task of a central bank is to control volume of credit in the economy. The general instruments of credit control are employed to control volume of credit whereas qualitative methods (selective credit controls) are employed to influence the direction of credit, The central bank, depending upon the circumstances, uses bank rate policy and open market operations to check fluctuations in the level of prices but rnay resort to variation in minimum cash reserve ratio and secondary reserve ratio to realise quick and immediate effect in controlling prices.

Qualitative methods to control credit have gained popularity in recent years. 'Through variations in margin requirements, changing number of instalments for loan repayments, and rationing of credit, the central bank aims at diversifying credit in the desired channels. The directives issued by the central bank and moral suasion have proved very effective measures of credit control. Besides, the threat of use of direct action prohibits commercial banks to flout the directives of the central bank.

7.7 KEYWORDS

Monetary Policy: That part of economic policy which regulates the level of money in the economy so as to achieve some desired policy objectives like price stability, growth, equilibrium in balance of payments. rtc.

Securities: Income yielding papers traded on stock exchange or in a secondary market.

4.8 ANSWERS TO CHECK YOUR PROGRESS

A) 1) i) False ii) False iii) True iv) False v) True
2) i) Commercial, central ii) central iii) central

B) 1) i) Monopoly of note issue, ii) Banker, agent and financial adviser to the state, iii) Bankers' bank, iv) Custodian of gold and foreign exchange reserves, v) Controller of credit, vi) Bank of central clearance, settlements and transfer, vii) Lender of last resort.
2) i) True iij False iii) True iv) True

C) 1) ii)
2) i)
3) ii)
4) i) True ii) False iii) True iv) True v) False
5) i) increase ii) deflation

7.9 TERMINAL QUESTIONS

1) What is a central bank? What makes a central bank different from commercial banks?
2) Discuss the traditional as well as promotional functions of a central bank in a modern economy.
3) What do you mean by selective credit controls'? In what way they are superior to traditional instruments of credit control'?
4) Differentiate between quantitative and qualitative methods of credit control and discuss the effectiveness of quantitative methods to control quantum of credit in an economy.
5) Discuss the working of the bank rate policy and open market operations and show how the two techniques are complementary to each other.

Note : 'These questions will help you to understand the unit better. Try to write answers for thern. But do not submit your answers to the university for assessment. These are for your practice only:

UNIT 8 RESERVE BANK OF INDIA

Structure

8.0 OBJECTIVES

After studying this unit, you should be able to:

- describe the functions of the Reserve Bank of India (RBI)
- state the system of note issue in India
- explain the principles followed for issuing the currency notes
- discuss various instruments of credit control adopted by the RBI
- appraise the monetary policy of the RBI.

8.1 INTRODUCTION

In Unit 7 you have learnt about the central bank. As you know, the central bank of any country is the apex institution in its banking system. Its authority to issue currency notes and its role as a government's banker and a bankers' bank impart to it a unique position in the banking structure of a country. The Reserve Bank of India (RBI) which is the central hank of this country, performs not only those functions which central banks in developed countries perform but also certain promotional and developmental functions to help the development of the less developed financial markets and institutions.

In this unit you will study in detail about the functions of RBI, system and principles of note issue by RBI, and the instruments of credit control adopted by RBI. It also critically examines as to how efficiently the RBI has used its monetary control measures to realise the stated objectives of its monetary policy.

8.2 FUNCTIONS OF THE RESERVE BANK OF INDIA

The Reserve Bank of India (RBI) is the central bank of India. It was established as a shareholders' bank on April 1, 1935. The RBI retaind this character for a little less than fourteen years. On January 1, 1949 it was nationalised and since lhen it has remained wholly state owned.

The RBI performs two types of functions: i) traditional functions of a central bank, and ii) developmental and promotional functions. The traditional functions are more or less the same which a central bank normally performs in both developed and less developed economies. In contrast, the developmental and promotional functions of a central bank operating in less developed countries are determined by the unique requirements of the economy in general and financial markets in particular. In India, the inadequacy of agricultural finance and lack of specialised institutions of long-term industrial finance have

mainly determined the developmental and promotional functions of the RBI.

8.2.1 Traditional Functions

The RBI was established on the model of the Bank of England. It was, therefore, entrusted with the task of performing all those functions which the Bank of England had been performing. These functions, which are usually known as traditional functions of a central bank are:

1) To issue currency notes
2) To act as a banker to the Government
3) To act as a bankers' bank
4) To control and supervise banks
5) To manage and control the foreign exchange
6) To control credit

1) **Issue of Currency Notes:** The RBI is the sole authority for issuing currency notes in India. We know that currency constitutes a significant part of the money supply in India. In 1989-90 around 57% of the money supply (considered in the narrow sense, that is, M) was in the form of currency. The issue of currency notes, therefore, becomes one of the principal functions of the RBI. All currency notes issued by the RBI are legal tender in India.

   The Reserve Bank of India Act permits the issue of currency notes in rupees in the denominations of two, five, ten, twenty, fifty, one hundred, five hundred, one thousand, five thousand and ten thousand or such other denominations not exceeding rupees ten thousand as the Central Government may specify. At present notes in denominations of rupees one thousand, five thousand and ten thousand are not issued. One hundred rupee notes are most important as they account for around half the total value of currency notes. The system and the principle of note issue by the RBI will be discussed later in this unit.

2) **Banker to the Government:** The RBI is a banker to both Central and State governments. As a banker it renders a variety of banking services to the government, including acceptance of money deposit, withdrawal of funds by cheques, receipts and collection of payments to Government and transfer of funds. The RBI is under statutory obligation to render banker's services to the Central Government. The State Governments, however, obtain these services from the RBI by virtue of agreements entered with it. The public debt management which is now done by the RBI was earlier the responsibility of the Government. Since the RBI operates in gilt-edged market, it has intimate knowledge of it. The RBI can thus provide useful advice to the government on the amounts, terms, conditions and timing of new bonds issue. In India, the Treasury Bills now constitute a significant proportion of the public debt of the Central Government. The Treasury Bills are issued by the RBI as the agent of the government. Apart from handling the public debt, the RBI also makes short-term advances to the government. These short-term advances are provided to overcome temporary difficulties of the government arising from shortfalls in their revenue.

   Finally, the RBI acts as an adviser to the government. The RBI, with its experts specialising in various areas, is in a position to advise the government not only on banking and financial matters, but also on issues pertaining to overall economic planning. The importance of this function has increased due to the need for integration between the monetary and fiscal policies.

3) **Bankers' Bank:** Like other central banks, the RBI does not deal with the public or business firms, it is only a bankers' bank. The commercial and cooperative banks avail the financial assistance from the RBI in the form of rediscounting of bills as well as loans and advances against approved securities, for periods not exceeding ninety days. The RBI has been entrusted with the task of channelising banking development on sound lines. Therefore, while giving advances to banks it has to discriminate between banks on the bases of their financial positions, lending policies and the securities offered. The RBI is within its powers to deny financial assistance to any bank wanting to borrow from it without assigning any reason.

4) **Control and Supervision of Banks:** Under the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 the RBI has been given extensive powers to control

commercial banks. The regulatory functions of the RBI relating to commercial banks cover their licensing, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation. For the purpose of control, the RBI conducts inspection of the banks and calls for returns and information from them. In case the operations of any bank are bound unsatisfactory, the RBI may recommend remedial measures to improve the functioning of that bank.

Any company wanting to do banking business in India must obtain a licence from the RBI in terms of the provisions sf the Banking Regulation Act. However, the banks in the public sector and the regional rural banks are not required to obtain licence to undertake banking business. Control over branch expansion of commercial banks is required for dispersal of banking facilities. A6 present the RBI encourages commercial banks to open their branches in rural and semi-urban ma..

In order to ensure that commercial banks are organised and operated on sound financial lines, the Banking Regulation Act has determined the minimum requirements of paid-up capital and reserves, transfer to reserve fund, and maintenance of cash reserve and other liquid assets. However, the most important supervisory function of the RBI is the inspection of banks. It safeguards the interests of the depositors and helps in developing banking system in conformity with the banking laws and regulations.

5) **Foreign Exchange Management and Control:** Foreign exchange management and control involves three main functions: (i) maintaining the external value of the currency, (ii) management of external reserves of the country, and (iii) exchange control. The RBI, being the central bank of the country, is required to perform all these functions. Presently the exchange value of the rupee is determined with reference to the daily exchange rate movements of a selected number of currencies of the countries which are India's major trading partners. The selection of the currency units and the weights to be assigned to them has been left to the discretion of the RBI. As a custodian of foreign exchange reserves, the RBI manages the investment and utilisation of these reserves. The exchange control is presently governed by the Foreign Exchange Regulation Act, 1973. The Act is administered by the RBI in accordance with the general policy laid down by the Central Government in consultation with the former.

6) **Credit Control:** Regulation of credit in accordance with the needs of the economy is perhaps the most significant function of a central bank. M.H. De Kock, a leading authority on central banking has observed, *"it (credit control) is the function which embraces the most important questions of central banking policy and one through which practically all other functions are united and made to serve a common purpose."* De Kock's observations are no doubt relevant in the Indian context. In this country the objective of economic policy is growth with price stability. The monetary policy relying primarily on credit control also aims at realising this objective. Thus the control of credit function of the RBI assumes unique importance. In order to regulate the supply of credit, the RBI used both quantitative and qualitative techniques which are discussed later in this unit.

8.2.2 Developmental and Promotional Functions

In the pre-Independence days the RBI did not perform any developmental functions. But after the country got Independence the RBI has begun performing a number of developmental and promotional functions. Broadly these may be classified under four heads. First, it has largely institutionalised agricultural credit. With this in view, it first hied to integrate indigenous bankers with the organised money market. Having failed in this attempt, it not only encouraged development of cooperative credit in rural areas but also exercised its licensing power in such a manner that commercial banks have now reached rural areas in a big way. Secondly, in order to channelise the savings of depositors particularly the small savers, it played an active role in the establishment of the Unit Trust of India (UTI). The UTI presently offers the best investment opportunity to both persons and institutions lacking in investment expertise. It ensures steady income, liquidity, low risk and expert management to its investors. Thirdly, by helping in setting up the National Bank for Agriculture and Rural Development (NABARD), the RBI has filled the gap in agricultural finance. The NABARD is the apex organisation in agricultural finance. Half of its share capita? has been provided by the RBI. Finally, the RBI has contributed greatly to the setting up of a number of development banks in India. In fact, the Industrial Development Bank of India (IDBI) was originally established as a subsidiary of the RBI. However, in 1976 it

became an autonomous institution.

Check Your Progress A

1) List the main functions of the Reserve Bank of India.

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2) State which of the following statements are True and which are False.

i) The Reserve Bank of India is the central bank of India.

ii) Right from the day the RBI was set up, it has been a public sector organisation.

iii) The RBI has the sole right to issue currency notes in India.

iv) The currency notes issued by the RBI are legal tender throughout the world.

v) The RBI is a banker to both Central and State Governments.

vi) The Treasury Bills are sold by the RBI for raising its working capital.

vii) The RBI is a bankers' bank.

viii) All commercial banks, including those owned by the Government, need a licence from the RBI to do banking business.

ix) The exchange control in India is managed by the Central government independently.

x) The developmental and promotional functions which the RBI has performed are the same as the, Bank of England has performed in the UK

8.3 NOTE ISSUE

As explained earlier in this unit, note issue is one of the basic functions of the RBI. The RBI has the monopoly power to issue currency notes. In this section we shall discuss the system and the principle of note issue.

8.3.1 System of Note Issue

In terms of the Reserve Bank of India Act, the RBI conducts note issue through two separate departments: 1) the Issue Department, and 2) the Banking Department. The Issue Department is liable for all the currency notes put into circulation from time to time. The Issue Department is required lo maintain eligible assets for equivalent value. In terms of the Reserve Bank of India Act, the assets of the Issue Department against which currency notes can be issued consist of gold, foreign securities, rupee coins, Government of India rupee securities and bills of exchange, and promissory notes payable in India which are eligible for purchase by the RRI. In practice, the distinction between the Issue Department and the Banking Department does not have much ecohomic significance because the assets of the two Departments keep on shifting frequently. However, the Issue Department does not hold some of the assets of the Banking Department. The assets which are not eligible for being held by the Issue Department are State Government securities and coins.

The responsibilities of the Issue Department include arranging the printing of notes from the currency printing presses of the Government of India, distribution of currency notes among the public and withdrawal ofnon-usable notes. On the other hand, the functions of putting the currency into circulation and its withdrawal from circulation is performed by the Banking Department. An illustration will help you to understand this clearly. Suppose, a commercial bank wants to withdraw Rs. 5 crores from its deposit with the RBI, the transaction will be handled by the Banking Department. The bank concerned will get currency in the denominations required by it and its account with the RBI will be debited for the amount withdrawn by it. For meeting this kind of demands the Banking Department holds stock of currency. Whenever it feels that its stock of currency is not sufficient, it replenishes it from the Issue Department against transfer of eligible assets. The commercial banks also make deposits with the RBI on a regular basis. Suppose, a particular bank tenders cash to the RBI to be deposited in its account, this cash will be received by the Banking Department and will be held as stock of currency. As a result of this receipt of cash, if there is surplus holding of currency in the Banking Department,. the excess cash ,will be transferred to the Issue Department in' exchange for the assets bf equal value. For exchanging currency notes of one denomination for another or for coins and vice versa, the

Issue Department deals with the public directly. As a related function of note issue, the RBI provides currency to the central and state governments to facilitate their transactions. From this point of view the RBI has made elaborate arrangements like maintaining offices of the Issue Department in a number of cities. At other centres the currency requirements are met through currency chests maintained by the RBI with the State Bank of India and its associated banks, other nationalised banks, and the Government Treasuries and sub-treasuries. The agency of the RBI, namely the State Bank of India or any other nationalised bank or the Treasury at which the chest is provided, can withdraw cash therefrom according to its requirements. It is also required to deposit into the chest any cash in excess of its immediate needs, as these funds can be withdrawn later when a need arises.

8.3.2 Principle of Note Issue

At the time of establishment of the RBI, gold standard (that is, a monetary system in which the currency of the country was directly or indirectly convertible into gold) was still prevailing at the international level.

Therefore, in India the principle of linking gold and foreign reserves to note issue was followed by adopting proportional reserve system. Under this system the RBI was required to maintain a reserve of gold and foreign securities (until January 1, 1949 sterling securities), not less than 40% of the total assets. However, at any time gold reserve was not to fall below Rs. 40 crore in value. The proportional reserve system requirement could be suspended with the previous sanction of the central government. Nonetheless the RBI was required to pay a tax on the shortfall in the statutorily required gold and foreign securities reserve. This system of note issue worked well for about two decades as it put a check on money supply in the economy and therefore, keeping an effective control on commodity and factor prices.

However, in 1956 with the adoption of the Second Five Year Plan a big push was to be given to development effon. Moreover, the process of monetisation became faster. Under such circumstances the demand for money was expected to increase which under the constraints of the proportional reserve system could not be easily met. Further, it was felt that blocking of foreign exchange in reserve to back issue of currency notes served no useful purpose; rather they serve greater purpose if used to cover unavoidahle deficits in the balance of payments. The system of note issue was, therefore, made more flexible in 1956. **The proportional reserve system was replaced by the** minimum **reserve system. This implies that the note issuing authority is under an obligation to maintain only a certain minimum of gold and foreign exchange reserve; the rest to be kept in the** Form of **other eligible securities.** In terms of the Reserve Bank of India (Amendment) Act, 1956 the minimum reserve prescribed was Rs. 400 crore in foreign securities and Rs. 115 crore in gold, adding upto Rs. 515 crore. In 1957 the provisions governing the minimum amount of reserve backing note issue were modified and the minimum requirement of the gold nnd foreign exchange reserve was fixed at Rs. 200 crore, of which the minimum value of gold was to be Rs. 115 crore. The Second Amendment Act of 1957 also empowered the RBI to dispense with reserve in foreign securities with the prior sanction of the Central Government. However, gold reserve of Rs. 115 crore is to be kept all the time. This system of note issue is no doubt flexible, but it does not provide for any check on inflationary tendencies.

Check Your Progress B

1) State the two methods of note issue which have been adopted in this country from the time the RBI was set up in 1935.

   i) .....

   ii) .....

2) State which of the following statements are True and which are False:

   i) The RBI conducts its note issue through the Issue Department and the Banking Department.

   ii) The Banking Department is liable for all the currency notes put into circulation.

   iii) The issue of currency notes is backed by the eligible assets.

   iv) The function of putting the currency into actual circulation is performed by the Issue Department.

v) For exchanging currency notes with coins or noles of one denomination for another, the Issue Department deals with the public directly.
vi) When the RBI was set up, the minimum reserve system of note issue was adopted.
vii) When proportional reserve system of note issue was adopted in this country, the, amount of reserve held in gold and foreign securities had to be at least 40% of the total assets.
viii) The proportional reserve system put a check on inflationary expansion of currency notes.
ix) The minimum reserve system of note issue follows the principle of flexibility in currency issue.
x) Presently the minimum gold reserve backing the note issue in India has to be of not less than Rs. 515 crore.

8.4 CONTROL OF CREDIT

As discussed earlier in this unit, control of credit is one of the most important functions of the Reserve Bank of India. In fact, through the RBI's credit control the government attempts to influence overall economic activity and the price level. In this section we shall first discuss the objectives of the monetary policy of the RBI as they provide its framework for credit control. Thereafter, the instruments of general credit control and direct credit regulation shall be discussed.

8.4.1 Objectives of Monetary Policy

Monetary policy refers to use of different instruments under the control of the central bank to regulate the supply of money and credit with the aim of achieving optimum levels of output and employment, price stability, balance of payments equilibrium or any other objectives decided by the State. At present the main objective of monetary policy in India is believed to be the promotion of economic growth coupled with high level of employment and price stability. It has induced economic growth by facilitating adequate volume of credit to industry, trade and agriculture. This obviously necessitated the RBI to follow policies that lead to expansion of credit.

But such a policy could lead to inflation. Therefore, the RBI has been following a cautious policy in credit expansion. To keep inflationary pressures under control, it has to restrain credit expansion and prevent flow of credit to socially undesirable activities like speculation and hoarding. Thus, the RBI's function has been to ensure adequate availability of credit to sustain the tempo of development without adversely affecting the internal price stability. This policy is often characterised as the **policy of controlled expansion.**

8.4.2 Techniques of General Credit Control

As discussed in the previous unit, the techniques of credit control are of two types: i) general or quantitative, and ii) selective or qualitative. The techniques of credit control in the first category are the bank rate, open market operations and reserve requirements. All these three methods affect loanable funds of the commercial banks, and thereby influence the volume of credit and thus total money supply. In the case of qualitative or selective credit control (which will be discussed later in this unit), the impact is on the direction of credit rather than its amount. Following are the general or quantitative techniques of credit control.

1) **Bank Rate: The bank rate is that rate of interest at which the central bank makes advances to commercial banks.** The central bank provides financial accommodation to banks against approved securities or purchases or rediscounts of eligible bills of exchange and other commercial papers. The purpose of making changes in bank rate is to vary the cost of securing funds from the central bank. If bank rate changes, it brings about changes in the structure of market interest rates, which in turn influences the level of economic activity. In an inflationary situation when policy of reducing money supply is to be pursued, the bank rate is raised with the hope that unwarranted investment activity will be checked. On the other hand, in the recessionary situation the bank rate is raised with the expectation that it will induce investment activity thereby providing impetus to overall economic activity.

However, the effectiveness of bank rate is rather limited in India. The changes in the

bank rate have very little operative significance. They merely indicate the changes in the direction of the credit policy of the RBI. It is for this reason that changes in the bank rate are almost always accompanied by some other techniques of credit control. Making his observations on the efficacy of the bank rate in India, H.V.R. Iyengar, a former Governor of the RBI, has remarked, *"in a planned economy which has a large public sector of investment and where government have a battery of powers of direct regulation of investment, the efficiency of bank rate changes is far less clear than it is in industrially advanced countries with a free economy."*

2) **Open Market Operations:** Open market operations are a technique of credit control by means of which the central bank changes the liquidity position of banks by operating directly in the market. Open market operations involve purchase and sale of government securities, foreign exchange, gold, bills of exchange and company shares by the central bank. However, in India open market operations are generally confined to the buying and selling of government securities, including Treasury Bills.

   Open market operations have two aspects. The first is the buying of securities. When the central bank purchases securities from banks, the latter's cash reserves increase and this improves their capacity to create credit. The other aspect is die selling of securities to the commercial banks which results in the decline of their cash reserves. As a consequence the banks' credit creation capacity is reduced.

   In India, the government securities market is narrow which is constraint on open market operations. A sizeable proportion of the government securities is held by some leading financial institutions and the volume of transactions in them is limited. Further on account of the virtual absence of a treasury bill market, open market operations of the RBI are entirely in government bonds. Given the narrow government securities' market, any attempt by the RBI to conduct large scale operations would unduly disturb security prices.

3) **Reserve Requirements:** The Central bank can change the reserve requirements and can thereby affect the credit creating capacity of the commercial banks. It is a direct and effective instrument of credit control. In India, 'the RBI regulates the liquidity of the banking system by two complementary methods: 1) cash reserve ratio, and 2) statutory liquidity ratio. The commercial banks are statutorily required lo maintain a cash reserve with the RBI equal to a certain percentage of deposits. This cash reserve ratio is prescribed by the RBI and can be in the range of 3 to 15 per cent of the deposits. **Whenever the RBI wants to put a check ow the expansion of credit, it raises the cash reserve ratio. Conversely, when credit expansion is to be induced, the cash reserve ratio is lowered.**

The effectiveness of changes in cash reserve ratio is limited by the tenaency of the commercial banks to offset their impact by liquidating their government security holdings. Therefore, along with a change in cash reserve ratio, a change in statutory liquidity ratio also becomes necessary. In India, until 1962 the commercial banks were required to maintain a liquidity ratio of 20% against their deposit liabilities. Cash in hand, cash with the RBI and other banks, gold and unencumbered approved securities constituted liquid assets. The statutory provision until 1962 enabled commercial banks to liquidate some government securities whenever cash reserve ratio was raised. Hence their capacity to create credit remained intact. The Banking Regulation Act was thus mended to plug this loophole. Now liquid assets are to be maintained exclusive of the cash balance maintained in terms of statutorily determined cash reserve ratio. The statutory liquidity ratio is also determined by the RBI.

8.4.3 Direct Credit Regulation

The regulation of credit by means other than control of bank reserves or the cost of credit is known as direct credit regulation or qualitative credit control. The widely used qualitative techniques of credit control are; (1) selective credit control, and (ii) moral suasion.

The quantitative or general techniques of credit control operate effectively in well organised money markets but are not very effective in countries where money markets are less developed. Qualitative techniques are more suitable for less developed money markets as these techniques help in regulating tlie distribution or direction of bank resources to

particular sectors of the economy in accordance with broad national priorities. In fact, qualitative credit control measures are considered complementary to general credit control and their effectiveness increases greatly when these are used together with general credit control.

1) **Selective Credit Regulation:** The RBI exercises selective credit control under the provisions of the Banking Regulation Act. The main techniques of selective control in India are: i) margin requirements for lending against selected commodities, ii) ceilings on levels of credit, and iii) charging of minimum rate of interest on advances against specified commodities. The first two techniques control the amount of credit, while the' thii technique operates through its impact on the cost of credit. These instruments of credit control are operated by the RBI in such a manner that they meet particular situations or achieve the desired direction of flow of credit. The margin against a particular commodity is determined keeping in view the socially and economically legitimate requirements of bank credit to that sector. Ceiling limits are fixed in order to restrict the capacity of the lending bank to grant credit against controlled commodities. The rate of interest mechanism is used to achieve policy objective of increasing or decreasing the credit flows to particular sectors. It is in fact through this technique that credit is made available to certain preferred sectors on concessional interest rates.

2) **Moral Suasion: Moral suasion refers to the advice given by the central bank to commercial banks in respect of their lending and other operations with the expectation that it will be accepted and the latter will operate accordingly.** Moral suasion may be quantitative in content, that is, the quantum of credit that a bank may grant may be fixed. It can also be qualitative, that is, banks may be advised not to give credit against certain commodities as their prices may be subject to speculative tendencies. In India, the RBI has found the technique of moral suasion quite useful. Since the nationalisation of major commercial banks, effectiveness of moral suasion has increased. An added reason for the effectiveness of moral suasion in India is that it is backed by the RBI's vast powers of direct regulation.

Check Your Progress C

1) State the three quantitative techniques of credit control operated by the RBI.

i) .....

ii) .....

iii) .....

2) List the three methods of selective credit control operated by the RBI.

i) .....

ii) .....

iii) .....

3) State which of the following statements are True and which are False.

i) Monetary policy refers to the policy of the central bank with regard to issue of currency notes.

ii) The RBI's monetary policy is often characterised as the policy of controlled expansion.

iii) Bank rate is the rate of interest charged by the central bank from the commercial banks on advances given to them.

iv) Bank rate policy is relatively ineffective technique of credit control in India.

v) Open market operations refer to buying and selling of government securities by the central bank in the open market.

vi) Open market operations are quite effective in India.

vii) Cash reserve ratio and statutory liquidity ratio when used by the RBI can prove to be effective for credit regulations..

viii) Since the money market in India is less developed, selective credit controls have no relevance in this country.

ix) 'Backed by the vast powers of direct regulation, the RBI has found the technique of moral suasion quite useful.

8.5 APPRAISAL OF THE MONETARY POLICY OF THE RBI

In developed countries the monetary policy generally aims at full employment with price stability. In developing countries, however, its objective is optimisation of growth with a high level of employment and price stability. In a country like India where all the time there has been a stress on accelerating the rate of growth, there has to be a continuous expansion of money supply and credit to meet the legitimate credit needs of industry, agriculture and trade. Therefore, the RBI's approach cannot be one of credit restriction. The RBI's responsibility under the circumstances is only to prevent availability of credit for unproductive and speculative purposes. **The** RBI **has, thus, rightly claimed that its monetary policy** is **one of controlled expansion.**

We have earlier discussed in this unit that the RBI possesses extensive powers of credit control, both quantitative and qualitative in nature. We shall now consider in this section as to how effectively the RBI has used these instruments of monetary control during the four decades of development planning. We are restricting our discussion to this period only because prior to 1951, the RBI did not have any specific monetary policy.

The era of development planning began in 1951. This was the period when most countries world over were pursuing the cheap money policy implying that the bank rate was kept low. In 1951, however, under the impact of the Korean War, inflationary pressures had built up and thus the RBI raised its bank rate from 3% to 3.5%. The rate of increase in money supply (M3) during the First Five Year Plan was as low as 3.4% per annum. But this was not sufficient to meet the increased demand for money arising from expansion in output and growing monetisation of the economy. Hence, the wholesale prices registered a decline of 2.7% per annum. Situation changed substantially during the Second Plan period. With increased emphasis on industrialisation and attempt to give a big push to the economy the demand for credit increased rapidly. The annual increase in the money supply (M3) thus was 8.2% during 1956-61. In order to moderate the growth of money supply, the RBI not only raised the bank rate to 4% in May 1957 but also resorted to selective credit controls. The price level, however, rose at an annual rate of **6.3%.**

During the Third Plan period, as against a modest performance on the production front resulting in a mere 2.3% annual increase in national income, M3 increased at 9.1% per annum. This gave rise to inflationary pressures which the RBI tried to contain by raising bank rate to 4.5% in January 1963 to 5% in October 1964 and further to 6% in Mitrch 1965. For four years from 1960 to 1964 the RBI operated quota-cum-slab system for providing refinance and in 1964 adopted a system of differential rates. Both these instruments aimed at credit restraints. In September 1964 the statutory liquidity ratio was raised from 20 to 25%. These measures should have been effective had the output position been satisfactory. But this was not to be, Due to failures on the supply front expansion in the supply of money in spite of adoption of credit control measures proved to be quite inflationary. In 1967-68 however when supply position improved due to encouraging performance on the production front the inflationary pressures eased and the bank rate was lowered from 6% to 5%.

During the period of Fourth Five Year Plan failures on the production front coupled with an increase in expenditure on defence and evacuee relief operations increased inflationary pressures. In this period the supply of money should not have been allowed to increase at a high rate. However, the annual rate of increase in M3 was 16.2% which certainly contributed to a lot of inflationary pressure. The RBI nonetheless tried different measures of monetary control. The net liquidity ratio was raised from 30% in April 1970 to 34% in January 1971 and further to 37% in 1973. The bank rate was raised in May 1973 from 6% to 7%. The cash reserve ratio was raised from 3% to 5% and further to 7% in September 1973. All these measures however failed to contain inflationary pressures and the wholesale prices rose by 20.2% in 1973-74. During the Fifth Five Year Plan period, while the national income increased at an annual rate of 5.3%, the supply of M3 increased at the rate of 17.9%. This did not ease inflationary pressures. Hence the RBI not only raised bank rate from 7% to 9%, the government also adopted certain fiscal measures. These measures arrested inflationary pressures to some extent and made the RBI a bit complacent about inflationary situation. As a result, the grip of the monetary policy was loosened. The cash

reserve ratio was reduced from 7% to 5% in June 1974 and further to 4% in December 1974. These were unwarranted concessions. The year 1979-80 was a drought year. In this year in spite of the fact that the national income declined by 5.5%, the supply of M3 was allowed to rise by 17.3%. As a consequence the wholesale prices rose by 17.2%.

The Sixth Plan period showed complacency on the part of monetary authorities. In this period in spite of 5.3% per annum increase in the national income the wholesale prices rose at the rate of 9.3%. This happened due to an annual increase of 16.9% in M3. The raising of bank rate to 10% in July 1981, fixation of cash reserve ratio and statutory liquidity ratio at 9%and 35% respectively in 1984 had little impact on inflationary situation.

During the Seventh Plan period the supply of money (M3) and national income rose at the rates of 17.6% and 5.4% per annum respectively. The wholesale prices during this period rose at the rate of 7% per annum. This indicates that the RBI did not move carefully on the money supply front. During the Seventh Plan period the cash reserve ratio was raised a number of times and was finally fixed at 11% effective from July 30, 1988. The statutory liquidity ratio was also revised upward a number of times and fixed at 38% in April 1987. These along with selective credit control measures proved ineffective to stabilise the general price level. In 1990-91 the inflationary situation had gone out of control, as the wholesale prices rose at about 12%. The RBI in this period did little to arrest price rise. Only the statutory liquidity ratio was raised to 38.5% in September 1990.

To sum up, the monetary policy of the RBI has been rather weak. All the time there seems to be some hesitation in operating drastic measures of monetary control. May be dilemma of the RBI in pursuing effective measures emanates from the risk of a decline in growth rate as a result of adoption of drastic credit control measures.

Check Your Progress D

1) State the monetary policy of the RBI in one sentence.

.....

.....

2) State whether the following statements are True or False.

i) In India the entire emphasis of monetary policy cannot be on credit restriction.

ii) During the first sixteen years of its existence, the RBI like many other central banks pursued cheap money policy.

iii) During the First Plan period, increase in the supply of money was in two digits which led to inflationary pressures.

iv) The annual increase in M3 was 8.2% during the Second Plan period.

v) During the Third Plan period an annual increase of 9.1% in M3 was not excessive because in this period the performance of the economy on production front was excellent.

vi) Various measures which the RBI adopted to check inflation during the Fourth Plan period proved to be effective.

vii) During the Fifth Plan period the annual rate of increase in M3 was as high as 17.9%.

viii) The monetary policy of the RBI was not entirely irrational when it allowed 17.3% increase in M3 in 1979-80.

ix) The monetary authorities in India were somewhat complacent to inflationary pressures during the Sixth Plan period.

x) Various measures of credit control adopted by the RBI during the Seventh Plan period proved to be quite effective as prices remained stable in this period.

8.6 LET US SUM UP

The Reserve Bank of India (RBI) was set up as the Central Bank of India on 1st April 1935. Though originally set up as a shareholders' bank, it was nationalised in 1949.

The RBI performs both traditional and developmental-cum-promotional functions of a central bank. The traditional functions of the RBI are: i) to issue currency notes, ii) to act as a banker to the government, iii) to act as a bankers' bank, iv) to control and supervise banks, v) to manage and control foreign exchange, and vi) to control credit.

In India, the main objective of the economic policy being growth with stability, the policies of RBI are also directed to realise this objective. Among the developmental and promotional functions, setting up of specialised institutions of industrial and agricultural finance have received particular attention of the RBI.

Of the various functions perfoimed by the RBI, the function of note issue is very important. The RBI conducts note issue through its Issue Department and Banking Department. Whenever there is demand for currency, the Banking Department offers eligible assets to the Issue Department and obtains currency. The assets against which currency can be issued are gold, foreign securities, rupee coin and bills of exchange and promissory notes payable in India. Presently, gold and foreign securities reserve against the issue of currency cannot be less than Rs. 200 crore, of which gold reserve in any case must not be less than Rs. 115 crore.

During the planning period, the RBI's attempt has been to ensure adequate supply of money and credit needed to sustain tempo of economic growth without generating unnecessary inflationarypressures. This approach is often known as the policy of "controlled expansion". The RBI can use all the instruments of credit control, hoth quantitative and qualitative. ' However, in India due to lack of adequate development of bill and the securities markets the bank rate policy and open market operations are not very effective. The RBI therefore relies more on changes in cash reserve ratio and statutory liquidity ratio. Selective credit controls are more suitable in India as they regulate the distribution and direction of hank resources to particular sectors of the economy. The RBI has also founcl that since it enjoys extensive powers of direct regulation moral suasion proves quite effective.

The RBI has all the possible weapons of monetary regulation in it; arsenal, yet its actual monetary control has been weak. The supply of money (M3) over the past two decades has increased at a rate exceeding 15 per cent per annum, while the national income rose at the rate of 4.1 per cent per annum. This has resulted in inflationary pressures. The measures adopted by the RBI to combat them have been found lacking.

8.7 KEYWORDS

Bank Rate: That rate of interest at which the central bank makes advances to commercial banks or rediscounts their hills.

Cash Reserve **Ratio:** Ratio of cash reserve to bank's aggregate deposits,

Currency Chests: Receptacles in which issuable notes are stored.

Exchange Control: Control of the monetary authority over all transactions involving foreign exchange.

Margin Requirement: A portion of the value of the security charged to the bank, which is required to be paid by the borrower out of his own resources.

Minimum Reserve System **of** Note Issue: A system of note issue requiring that a certain minimum amount of reserve backing of note issue should be in the Form of gold and foreign securities.

Money Supply (M3): Supply of currency plus all deposits with banks.

Moral **Suasion:** An instrument of central bank's pressure upon the lending activities of commercial banks through exhortations that they follow certain restrictive practices.

Open Market Operations: Purchase or sale of eligible securities by the central bank in the open market.

Proportional Reserve **System** of Note **Issue:** A system of note issue requiring that a certain percentage of reserve backing the note issue should be in the form of gold and foreign securities.

Selective Credit **Control:** Such credit control that it regulates the distribution or direction of bank resources to particular sectors.

Statutory Liquidity Ratio: The ratio of liquid assets to total demand and time liabilities determined statutorily.

8.8 ANSWERS TO CHECK YOUR PROGRESS

A 2) i) True ii) False iii) True iv) False v) True vi) False vii) True viii) False ix) False x) False

B 1) i) The Proportional Reserve System
ii) The Minimum Reserve System

2) i) TNC ii) False iii) True iv) False v) True vi) False vii) True viii) True ix) True x) False

C 1) i) Bank Rate Policy
ii) Open Market Operations
iii) Reserve Ratio Changes

2) i) Margin Requirements Changes
ii) Ceilings on Levels of Credit
iii) Charging of Minimum Rate of Interest on Certain Advances

3) i) False ii) True iii) True iv) True v) True vi) False vii) True viii) False ix) True

D 1) The monetary policy of the RBI can be characterised as the policy of controlled expansion.

2) i) True ii) True iii) False iv) True v) False vi) False vii) True viii) False ix) True x) False

8.9 TERMINAL QUESTIONS

1) Discuss the various functions of the Reserve Bank of India.
2) Explain the system of note issue in India.
3) Explain the methods of credit control adopted by the Reserve Bank of India. Discuss their relative importance also.
4) Why is the Reserve Bank's monetary policy often characterised as the policy of controlled expansion? Critically evaluate the monetary policy of the Reserve Bank of India during the four decades of developmental planning.

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.

UNIT 9 INDIAN MONEY MARKET

Structure

9.0 OBJECTIVES

After reading this unit, you should be able to:

- define money market
- distinguish between money market and capital market
- explain the role and significance of money market in a modem economy
- identify components of Indian money market
- identify drawbacks of Indian money market which make it an underdeveloped money market
- list the steps initiated by the RBI to remove defects of Indian money market.

9 3 INTRODUCTION

Financial markets and institutions have acquired great importance in the modem economies as finance has becqme an integral part of modern business and an essential component of economic development. Financial markets deal in financial assets and credit instruments of various kinds such as currency, deposits, cheques, bills and bonds, etc. Financial markets, in essence, are the credit markets. They cater to the various credit needs of the individuals, firms and institutions on the one hand, and help in mobilisation of savings in the economy on the other.

The structure of financial markets can be studied from three angles: 1) functional, 2) institutional; and 3) sectoral. The functional classification is based on the term of credit (i.e., short-term or long-term credit), the institutional classification is based on the nature of organisation (i.e., organised or unorganised credit market) and the sectoral classification is based on the credit arrangements for various sectors like agriculture, trade, industry, etc.

Based on the functional classification of the financial markets, we thus have the **money market** dealing in short-term credit and the **capital market** handling long-term credit. In this unit you will study the nature, structure, and drawbacks of the money market in India. You will also study the steps taken by the government to improve it.

9.2 WHAT IS MONEY MARKET?

Money market refers to the whole network of financial institutions dealing in short-term funds which provides an outlet to lenders and a source of supply of fund$to borrowers. The short period varies from a day to a few months. **Funds borrowed against different types of credit instruments such as bills of exchange, short-term securities, promissory notes and treasury bills drawn for a short period, etc., are called near**

money. Thus, the term money market may sound misleading as it does not deal in cash or money but in near money assets.

Elaborating on the essential meaning of money market, the RBI describes money market as: "*the centre for dealings, mainly of short-term character, in monetary assets. It meets the short-term requirements of borrowers and provides liquidity or cash to them by the lenders. It is the place where short-term surplus investible funds at the disposal of financial and other institutions and individuals are bid by borrowers, again comprising institutions and individuals and also by the Government.*'

Demand for short-term funds comes from Government, business concerns and private individuals. The Government probably the biggest borrower everywhere, requires short-term funds to meet current deficits. Firms need funds for working capital requirements and also to carry additional stocks. Other important borrowers include stock exchange brokers,, manufacturers, merchants, etc. The supply of loanable funds comes mostly from the central bank of the country, commercial banks and other financial institutions.

The money market may be distinguished from capital market. The capital market is concerned with the supply of and demand for long-term investible funds, whereas the money market is essentially concerned with only short-term funds. The capital market deals in bonds, stocks and shares of corporate sector and mortgage credit for long period, while money market deals with short-term needs such as working capital requirements of business concerns, individual borrowings and short-term government obligations. However, these two markets are closely related with certain amount of overlapping as the same institutions, many a time, deal in both types of loan.

Check Your Progress A

1) Fill in the blanks:
   i) Money market provides ..... term funds.
   ii) In money market, funds are borrowed against various ..... .
   iii) Distinction between money market and capital market is based on ..... classification.
2) State whether the following statements are True or False.
   i) Money market deals in money.
   ii) Capital market is a part of money market.
   iii) Capital market and money market are closely related to each other.
   iv) Financial market and credit market are essentially the same.

9.3 STRUCTURE OF THE INDIAN MONEY MARKET

The Indian money market is divided into three distinct parts: 1) organised sector, 2) unorganised sector, and 3) cooperative sector. However, technically the cooperative sector may be considered as a part of the organised sector.

1) **Organised** Sector: This sector consists of the Reserve Bank of India, State Bank of India and its subsidiaries, foreign exchange banks, nationalised banks, all scheduled and lion-scheduled commercial banks and the regional rural banks. Besides, some non-banking companies and financial institutions like the Life Insurance Corporation of India, the General Insurance Company of India, the Unit Trust of India, etc., also operate in the organised money market. Chit funds and post-office savings banks also play a significant tole specially in semi-urban areas and small towns.

2) **Unorganised** Sector: This part of the money market consists of indigenous bankers and the money-lenders called mahajans, seths, shroffs, chettiars, etc., in different parts of the country. Many of the indigenous bankers combine banking business with trading and commission business, whereas others deal primarily in banking activities. The indigenous bankers deal in 'hundis' and 'promissory notes'. Nearly fifty per cent of the internal trade depends on finance from the unorganised sector.

3) Cooperative Sector: The cooperative sector occupies a somewhat intermediary position between the organised and the unorganised parts of the money market. This sector primarily comprises cooperative banks, rural banks and cooperative credit societies. Their main purpose is to supplement the indigenous sources of rural credit.

They finance farmers, weavers, rural artisans, etc., in their production and marketing activities.

The money market is composed of many financial agencies that deal with different types of short-term credit even in the organised sector. We may discuss the following important components of money market.

1) **Call Money Market:** It is an integral part of developed money market which provides credit facility for a very short duration, not exceeding seven days in any case. It is the most active and sensitive part of the organised segment of the money market. Bill brokers and stock-brokers usually borrow call loans from commercial banks against which no collaterai security is demanded. However, in India inter-bank call money is very common. Apart from the scheduled and non-scheduled commercial banks, foreign banks and cooperative banks, other financial intermediaries like the LIC, the GIC, and the UTI have also started actively participating in the call money market.

2) **Bill Market:** The bill market or the discount market as it is called in London, is a sub-market in which short-tenn bills are bought and sold. The most important types of bills are treasury bills, bank bills and trade bills which are usually drawn for a period of 91 days. As these bills are basically post-dated cheques, they are easily discounted in the money market. In India, there is no well developed bill market, though major banks discount bills of established customers.

3) **Acceptance Market:** It refers to the market for bankers' acceptance involved in trade, both internal as well as foreign trade. Acceptance houses, in whom both the importers and exporters have full confidence, act as agents. They get commission from both the exporters and importers for this service. The acceptance market helps international trade by providing guarantee for payment on time and thereby reduce the risk involved in foreign trade. The bill is drawn on behalf of the acceptance house and not on the importer so that the bill is easily discounted at a relatively lower rate of interest.

4) **Collateral Loan Market:** When loans are offered against collateral securities like stocks, bonds, merchandise, etc., the loans are called **collateral loans.** The chief lenders in the money market are commercial banks. The borrowers take collaterals in the form of overdrafts and cash credits.

It should be noted that the different sub-markets, as discussed above, can be combined into one market. For example, call loans are taken by those who deal in discount market and many of them who discount bills also act as acceptance houses. On top of them all is the central bank of the country which is an apex body central bank is an accepted leader of the money market which controls and guides the entire activity of the money market.

9.4 CHARACTERISTICS OF INDIAN MQNEY MARKET

9.4.1 Features of a Developed Money Market

A money market is considered 'developed' if it satisfies the following conditions:

1) Highly organised commercial banking system.

2) Presence of an efficient central bank.

3) Continuous supply of negotiable securities such as bills of exchange, treasury bills, short-term Government bonds, etc.

4) Existence of a number of sub-markets, each specialising in a particular type of short-term asset. The larger the number of sub-markets, the broader and more developed will be the structure of the money market.

5) Moreover, the sub-markets should form an integrated structure in which every segment of the money market is in intimate relationship with each other. This is essential to ensure uniformity of interest rates in various sub-markets and also for the free flow of funds.

There are not many developed money markets in the world which have all the abovesaih characteristic features. London and New York money markets are the best examples of

developed money markers. Other examples of international financial centres are Paris, Zurich, Frankfurt, Amsterdam and Vienna which contain most of the features of developed money markets.

9.4.2 Nature of Indian Money Market

Indian money market is not a very well organised and truly coordinated entity so as to be placed in the category of highly developed money market. In fact, it is composed of two categories of financial agencies: 1) organised, and 2) unorganised segments. The organised sector contains well-established, scientifically-managed financial institutions, whereas unorganised sector comprises agencies which have diversified policies. without uniformity and consistency in the lending business. In between these two segments lie post-office savings banks and the cooperative banks.

1) Organised Segment: At the apex level there is RBI, which is leader of the money market and controls the banking sector. Besides, there are joint stock commercial banks which are of two types: (i) scheduled banks and (ii) non-scheduled banks. Since July 1969, all major banks in India have been nationalised. Besides, State Bank of India and its subsidiaries are also owned by the Central Government. The public sector banks control nearly 90% of the finances of organised banking system. There are fifteen foreign exchange banks as well. Besides, the post office savings banks, cooperative banks, rural banks and chit funds also play a significant role by mobilising savings and catering to the needs of small holders particularly in semi-urban and rural areas.

2) Unorganised Segment: It comprises of indigenous bankers and money-lenders including unregistered chit fund companies. In India there are more than 2,500 indigenous bankers who provide nearly 50% of the rural finance. The financial activities of indigenous bankers and money-lenders are mostly confined to small towns and rural areas which lack modem banking facilities. They operate in a limited way in big cities also. They basically cater to the needs of local demand for funds and grant loans to those who are personally known to them, normally against collateral securities to minimise risk.

Hence, it is evident that Indian money market is neither a well organised nor a coordinated and homogeneous entity. Some of the major features of Indian money market can be listed as under:

1) Duality: The Indian money market is composed of two segments, viz., the organised and unorganised sectors. The former consists of modem, well organised and scientifically operating financial institutions like the RBI, scheduled and non-scheduled banks in the private and public sectors, foreign banks, post office saving banks and the cooperative banks falling somewhat between organised and unorganised sectors of the money market. The unorganised sector consists of widely scattered indigenous bankers, money-lenders, chit funds, etc., which lack scientific organisation.

2) Predominance of Government and Semi-Government Securities: The bill market, an important and the most sensitive constituent of the organised money market, is also underdeveloped in India. As compared to advanced countries, there is great paucity of good commercial bills in the country. Hence, the lion's share of the securities bought and sold are government and semi-government securities.

3) Absence of Discount Houses: There is almost complete absence of acceptance business and discount houses in the Indian money market. This is due to the fact that there is no market for commercial bills. Traders in India resort to hundis rather than scientifically drawn bills of exchange.

4) Seasonal Stringency of Funds and Fluctuations in Interest Rates: Indian economy, being essentially agricultural in nature, has its bearing on activities of the Indian money market. Considering the demand for funds, there are busy and slack seasons in India. The busy season coincides with production and marketing activities of agricultural produce. This requires additional funds during October/November to April/May which creates monetary stringency, and results in higher interest rate during the busy season and lower interest rates in slack season.

5) **Limited Scope of Banking Facilities:** Before nationalisation of 14 major banks in India in 1969, there was one branch for about 65,000 persons with majority of banks

being in big cities only. There were practically no banks in villages and small towns. Situation has improved a lot due to expansion of branches during the last 20 years. Some banking facilities have no doubt reached rural areas and small towns, but these are inadequate.

6) Isolation from International Money Markets: The Indian money market has reniaincd more or less isolated from foreign markets. There is hardly any movement of funds between the Indian money market and the foreign markets. This is partly due to exchange control restrictions on capital movements and partly due to underdeveloped nature of the Indian money market.

Check Your Progress **B**

1) State whether the following statements are True or False.
   i) The Indian money market is a well-organised market.
   ii) All non-banking companies are a part of the unorganised sector of Indian money market.
   iii) The short-tern1 bills are basically post-dated cheques and, therefore, easily discountable.
   iv) Acceptance houses act as agents in which either importer or exporter has full confidence.
   v) The Indian money market is more or less isolated from foreign markets.

2) Which of the following are the major features of Indian money market?
   i) Predominance of government and semi-government securities.
   ii) Highly organised commercial banking system.
   iii) Existence of a number of sub-markets, each dealing in a particular type of short-term assets.
   iv) Existence of duality.

9.5 PROBLEMS OF INDIAN MONEY MARKET

9.5.1 Nature of Problems

In terms of both organisation and development, Indian money market is not comparable to any of the developed money markets of the world like the London or the New York money markets. It also cannot match tlie extent of resources, stability and elasticity of these developed money markets. It also suffers from a number of drawbacks, of which the following are more prominent:

1) Lack of Integration: The organised and tlie unorganised sectors of Indian money market are completely separate from each other in their financial activities. There is more of competition than cooperation and coordination among various constituents of the Indian money market. The banks compete among themselves rather than having a healthy cooperation. The RBI has no effective control on the indigenous bankers as they seldom use rediscounting facilities offered by the organised banking system. This has made monetary policy of the RBI (specially tlie bank rate policy) almost ineffective. Besides, there is no all India money market in its true sense though there are only reasonably developed local money markets.

2) Difference in Rates of Interest: In India, interest rates prevailing in different parts of the country are not uniform, i.e., there is coexistence of high as well as low interest rates in different parts of the money market. Even the rates of interest charged by banks differ widely depending upon tlie locality in which they function, the type of security that is offered, the nature of the advances and the competition they have to face. Besides, interest rates during busy season are always higher than what they are during slack season. Another peculiar feature of the Indian money market has been that short-term interest rates are higher than long-term interest rates. However, there has been some improvement in this regard in recent years.

3) Relatively Under Developed Banking Habits: Even after considerable branch expansion, the use of cheques and credit instruments is somewhat less popular. People prefer cash transactions. Besides, hoarding is a popular habit in India, specially in rural and semi-urban areas. This has led to investments in gold and silver ornaments and other non-monetary assets.

4) Shortage of Funds: The Indian money market suffers from shortage of funds as demand for loanable funds always exceeds their supply. The shortage becomes more pronounced in the busy season. Widespread poverty and huge population in India has resulted in low per capita income which has limited the capacity to save. Apart from this. the existence of black money has also considerably reduced the supply of financial resources in the Indian money market.

5) Absence of an Organised Bill Market: In spite of the New Bill Market Scheme of the RBI in the year 1970, organised bill market is yet to fully develop in India. It is due to a variety of reasons like: (i) lack of uniformity in drawing bills between different parts of the country, (ii) general preference for cash transactions, (iii) high stamp duty on usance bills, etc.

6) Inadequate Banking Facilities: Even after expansion of branch banking in the post-nationalisation period, the money-lenders still continue to be the primary source of credit to the Indian farmers and village artisans. This has hampered the process of mobilisation of small savings in the countryside. Apart from this, lack of clearing house facilities and of specialised banks to provide credit to small and tiny sectors are some of the other problems faced by lndian money market.

9.5.2 Role of RBI in Tackling the Problems

The Bill Market Scheme was introduced in 1952 by the RBI to grant loans to commercial banks against approved usance bills of their customers. To provide loans liberally to genuine exporters in 1958, this facility was extended to cover export bills as well. The New Bill Market Scheme was introduced in 1970 to revitalise the money market and eliminate certain defects of the 1952 Bill. The new bill scheme proved to be a major step in creating a genuine bill tnarket in India. Some of the shortconlings of the money market have been overcome after nationalisation of commercial hanks and introduction of the New Bill Market Scheme like expansion of branch banking in semi-urban and rural areas, inter-linking of different parts of the money market, rationalisation of interest rates, and reduction in seasonal stringency of money. However, the RBI has not been able to achieve the desired results as the new scheme pravides benefits to scheduled banks only and it remained concentrated mainly in the fields of trade and industry and has failed to help the agricultural sector. Moreover, the banks have to fulfil many prerequisites to avail of the rediscounting facility.

Hence, a lot more remains to be done by both the Government as well as the RBI to improve the working of the money market so that India has a really developed money market.

9.5.3 Suggestions fur Improvement

In order to improve the functioning of the money market the following steps need to he initiated by the RBI:

1) Regulation of Indigenous Banking: For proper organisation of the Indian money market, registration of indigenous bankers may be made compulsory. They should be brought under the control of RBI and should be provided with loan facilities.

2) Standardisation of Hundis: In order to popularise commercial bills, it is essential to standardise indigenous Hundies and bills so that uniformity of rules can be achieved with regard to the contents, language and usage. This will help in developing the bill market in the real sense.

3) Expansion of Rediscounting Facilities: For wider use of bills, the RBI should offer all sorts of facilities for rediscounting of bills. This will help in expansion of financial activities in the money market and reduce stringency of funds as well.

4) Clearing House Facility: For expansion of banking services, it is essential to expand clearing house facilities throughout the country. For this purpose, the number of clearing houses should be increased and improved on the pattern in which European clearing houses function,

5) Lowering Stamp Duty: To popularise the use of bills of exchange, the stamp duty should be reduced to a reasonable level.

6) Other Measures: In addition to the above steps, the following measures may also help in improving the money market in India:

i) Establishment of acceptance houses and discount houses.
ii) Expansion of the functions of all India Bankers Association.
iii) Development of a system of agricultural bills against standing crops.
iv) Cheaper and quicker transfer of funds facility.

Check Your Progress C

1) State whether the following statements are True or False.
   i) Indian money market may not be as organised as any developed money market but it is definitely equally stable and elastic.
   ii) Various constituents of Indian money market compete more than cooperate with each other.
   iii) The dominance of money-lenders in Indian money market remains almost intact even after expansion of banking in India.
   iv) Indigenous banking sector should also be brought under the control of RBI.
   v) Uniform rates of interest prevail in different parts of our country.

2) Fill in the blanks:
   i) RBI introduced the New Bill Market Scheme in the year .....
   ii) Black money in India has significantly .....the supply of financial resources in the money market.
   iii) The organised and unorganised sectors of Indian money market are completely ..... from each other in their financial activities.
   iv) The Indian money market suffers from .....of funds.

3.6 LET US SUM UP

The money market is one of the most important institutions in a modern economy. The industrial growth and expansion of trade, particularly foreign trade, are greatly facilitated by the existence of a developed money market. The usefulness of the money market is not limited to business and industrial sectors but is available also to the state and the central bank authorities to implement their policies effectively for realising desired goals of economic activity.

Money market may be distinguished from the capital market. The money market is the collective name given to various firms and institutions which deal in short-term credit, i.e., near money assets. The capital market is concerned with the supply of long-term investiblc funds.

The Indian money market is composed of two segments—organised and unorganised. The organised segment comprises call money market, bill markct, commercial hanks, cooperative and rural banks, post office savings banks and registered chit funds, The RBI is the leader of the organised money market. The unorganised segment includes indigenous banks and the money-lenders.

The Indian money market cannot be termed as a developed money market like the London and New York money markets are. The presence of a large unorganised sector, lack of developed bill market, lack of banking facilities in the rural areas and stringency of funds specially in busy season have resulted in keeping Indian money market underdeveloped,

In order to tide over this difficulty, the RBI introduced a New Bill Scheme in the year 1970. The Government also nationalised 20 major commercial banks to help RBI to tighten its control on the money market. Though various steps initiated so far have definitely helped in improving the performance of the money markct, a lot more remains to be done. In this regard the following suggestions will be worth consideration and implementation by the RBI: popularising the use of hills by standardisation of hundis, promotion and expansion of bill market: regulation of indigenous bankers and money-lenders, creation of a network for clearing house facilities, lowering of stamp duty on usance bills, etc. These measures will go a long way to enhance the effectiveness of monetary policy of the RBI and help develop the Indian money market.

9.7 KEY WORDS

Acceptance Market: Refers to the market for banker's acceptances involved in trade transactions.

Call Money: Credit facility for a very short duration, not exceeding seven days.

Capital Market: Concerned with the supply of and demand for long-term investible funds.

Collateral Loan: A loan offered against securities like stocks, bonds, merchandise, etc.

Indigenous Bankers: Those dealing in Hundis and promissory notes.

Money Market: Refers to the institutional arrangements facilitating borrowing and lending of short-term funds.

Treasury Bills: Bills issued by RBI on behalf of the Government.

Usance Bills: Bills with a time specified maturity.

9.8 ANSWERS TO CHECK YOUR PROGRESS

A 1) i) short ii) credit instruments iii) functional
2) i) False ii) False iii) True iv) True

B 1) False ii) False iii) True iv) False v) True
2) i and iv

C 1) i) False ii) True iii) True iv) True v) False
2) i) 1970 ii) reduced iii) separate iv) shortage

9.9 TERMINAL QUESTIONS

1) What is meant by money market? Discuss the significance of money market in a modem economy.
2) Discuss various constituents of money market and their functioning in India.
3) Discuss various characteristics of a developed money market. Can Indian money market be termed as developed money market?
4) Distinguish between money market and capital market. Highlight the drawbacks of Indian money market which make it an underdeveloped money market.
5) Write the characteristics of Indian money market. Outline the measures to improve the functioning of Indian money market.

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.

SOME USEFUL BOOKS

Gupta, S.B., 1982. *Monetary Economics,* S. Chand & Co: New Delhi. (Chapters)

Mishra, S.K., 1990. *Money, Income and Financial Institutions,* Pragathi Publications: Delhi. (Chapters 15-18, 20, 21, 23)

Mithani, D.M., 1990. *Money Banking International Trade and Public Finance,* Himalaya Publishing House: Delhi. (Chapters 11, 13, 14, 16)

Sundaram, K.P.M., 1989. *Money, Income and Financial Institutions,* Sultan Chand & Sons: New Delhi. (Part II Chapters 1-7, Part V Chapters 2 & 6)

UNIT 10 NON-BANK FINANCIAL INTERMEDIATION—AN OVERVIEW[2]

Structure

10.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning of financial intermediation
- describe the role of non-bank financial intermediaries
  identify various types of non-bank financial intermediaries in India
- describe the importance and role of Life Insurance Corporation of India, Gederal Insurance Companies and Unit Trust of India as non-banking financial intermediaries.

10.1 INTRODUCTION

In the previous block you have studied the theory and practice of commercial banking. You have also learnt about the role of various banking institutions particularly the commercial banks and the central bank in the economic development of a country.

In this unit you will study the role of various non-bank financial instilutions including the Life Insurance Corporation of India, General Insurance Companies and the Unit Trust of India. Before taking up a detailed discussion of these institutions, it is necessary to know the meaning of financial intermediation and the manner in which non-bank financial intermediaries differ from the financial intermediaries, viz., commercial banks.

10.2 NON-BANK FINANCIAL INTERMEDIATION

10.2.1 What is .Nan-bank Financial Intermediation?

Financial intermediation is the modern term used for 'Financial Institutions'. The financial intermediaries act as mediators to bring together the savers and users of capital. They mobilise money from the savers by selling securities to them, and lend the same to the borrowers. Broadly, the term financial intermediaries can be applied to a variety of institutions, some of which are listed below:

- Commercial Banks
- Insurance Companies
- Provident Fund Organisations

- Investment Companies.
- Special Financial Companies
- Share Brokers and Dealers
- Hire Purchase Finance Companies
- Chit Fund Companies

Of these institutions, the commercial banks come under the category of bank financial intermediaries, since they mobilise money from the public and pay them on demand. They lend money to individuals as well as business firms mainly on short-term basis. Generally, commercial banks do not directly participate or undertake promotional activities for the development of business or industry.

On the other hand, the non-bank financial institutions, acting as financial intermediaries, mobilise savings from the public and lend the same to business firms. All the other institutions specified above, other than commercial banks, are non-bank financial intermediaries.

The following are the differences between the bank and non-bank financial intermediaries.

1) The banking institutions mobilise demand deposits and other deposits from the public and pay the same on demand to the customers. Non-bank financial institutions generally pay back the money taken from the public only after a specified time.
2) The banking institutions generally provide loans to individuals as well as business firms mainly on short-term basis. Non-banking financial institutions lend funds mainly on term basis to business firms only. They also subscribe for the shares and debentures of industrial concerns.
3) The commercial banks do not directly participate in the promotional activities in general. The non-bank institutions, on the other hand, undertake many promotional activities for the rapid industrial development of the country.
4) All the banking institutions in the country are in the organised sector. The Banking Companies (Regulation) Act, 1949 is applicable to all banking institutions. The non-bank financial intermediaries, on the other hand, come under the categories of both organised and un-organised sectors.

10.2.2 Role of Non-bank Financial Intermediaries

The non-bank financial institutions acting as intermediaries play a crucial role in bringing together the savers and the borrowers. The intermediation process of these institutions helps the individuals to invest their funds safely and enables business firms to borrow funds without problems.

For instance, an automobile manufacturing firm wants to borrow Rs. 100 crore. In the absence of financial intermediaries it has to seek out individuals who would lend that amount, which is a very difficult problem. In the same way assume that you have a sum of Rs. 1,000 to lend. How would you, as an individual, find a borrower who needs an amount of Rs. 1,000 only. It is in this context that the financial institutions come into the picture. They solve the problem by providing benefit to all'the parties involved. They serve as intermediaries between the savers (by pooling' their funds) and the users (by lending them the money thus pooled). In addition to this the pooling of funds provides certain administrative economies of scale.

Acting as intermediaries, the non-bank financial institutions help the individuals, business firms and the nation as a whole in the following ways:

1) The non-bank financial institutions help the individual investors by providing them triple benefits viz., low risk, steady return and capital appreciation.
2) They help the business firms in securing funds at reasonable cost and in time. They take the risk of mobilising savings from numerous small investors. The business firms are, thus, relieved of the problem of approaching small investors scattered throughout the country.
3) The non-bank financial institutions also help the different sectors of the economy according to the priorities fixed by the Government from time to time.
4) By providing financial help on softer terms to the enterprises set up in backward areas, these institutions help in correcting regional imbalances in the country.
5) When the programmes of rapid industrialisation get bogged down due to the inadequacy of finance. these non-bank financial institutions render valuable

assistance in the form of loans, underwriting services or direct subscription of shares and debentures.

6) They provide technical, financial and managerial assistance to entrepreneurs. These institutions undertake various promotional activities such as the formation of project ideas, conducting viability studies, the implementation of the projects, etc. Thus, financial institutions play a very crucial role in accelerating the pace of industrial development.

10.2.3 Types of *Non-bank Financial Intermediaries*

On the basis of the functions they perform, these non-bank financial institutions are classified broadly into the following three categories :

1) Investment Trusts : These institutions are also known as investment banks. They mobilise the savings of scattered masses and channelise them to productive uses. They invest their excess money in various securities in addition to the provision of long-term loans. They also undertake merchant banking activities including underwriting of securities. This type of institutions include the Life Insurance Corporation of India. (LIC), General Insurance Corporation of India (GICI) and the Unit Trust of India (UTI).

2) Development **Banks** : These institutions are also known as special Financial Institutions. They provide long-term financial assistance to industrial undertaking in various forms. Since they also undertake many promotional functions, they are known as development banks. These institutions include Industrial Finance Corporation of India (IFCI). Industrial Credit and Investment Corporation of India (ICICI) and Industrial Development Bank of India (IDBI) at national level while the State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs) exist at the State level.

3) Other Institutions : Generally some institutions do not provide financial assistance. They mainly undertake promotional activities and provide various services to entrepreneurs. These institutions include National Small Industries Development Corporation (NSIC), State Small Industries Development Corporations (SSIDCs) and Technical Consultancy Organisations (TCOs).

We first discuss the role of investment trusts in this unit, followed by all India level term-lending financial institutions in Unit 11 and state level term-lending financial institutions in Unit 12.

Check Your **Progress A**

1) Non-bank institutions are broadly of three kinds. What are they?

.....

.....

2) Which of the following statements are True and which are False ?

i) Financial intermediaries bring together the demanders and suppliers of capital.

ii) Non-bank institutions lend money to individuals and business firms.

iii) Banking institutions provide funds mainly on long-term basis, while non-banking institutions look after the short-term loans.

iv) To entrepreneurs in backward areas the non-bank institutions provide financial help at easy terms.

v) State Small Industries Development Corporations mainly provide consultancy and other such services to the entrepreneurs.

10.3 LIFE INSURANCE CORPORATION OF INDIA (LIC)

The Life Insurance Corporation of India (LIC) was constituted under the LIC Act, 1956 as a wholly-owned gavernment corporation by nationalising 244 private companies operating from 97 centres in India. The main objective behind the establishment of this corporation was to carry on the business of life insurance to the best advantage of the community and to channelise the funds into investment in accordance with plan priorities.

Objectives

The following are the specific objectives of the corporation:

1) Spreading the gospel of life insurance as far and wide as possible, reaching out beyond the more advanced urban areas into the previously neglected rural areas;
2) Affording life insurance protection to every eligible man and woman in the country through insurance schemes suited to different sections of the community;
3) Mobilising public savings or effectively for nation building activities;
4) Providing complete security and prompt and efficient service to the policy-holders at economical rates.
5) Conducting its business with the utmost economy and with the full realisation, that the money belongs to the policy-holders, investing the funds in such a way as to secure maximum yield consistent with the safety of capital;
6) Developing a dynamic and vigorous organisation under a management conducted in a spirit of trusteeship.

Resources

When the LIC was nationalised, an initial capital of Rs. 50 crore was provided by the Government of India. Premiums paid by the policy holders are the principal source of funds of the LIC. Besides, the LIC receives interest, dividends, repayments and redemptions which add upto its investible resources.

Investment **Policy**

The Corporation is essentially an investment institution. Its investment policy has been designed taking into account the cardinal principles of safety of the principal amount. Diversification of funds in terms of various types of securities, number and types of enterprises, maturity and regions. The corporation is supposed to function on business principles and its investment policy is guided by the consideration of the interest of its policy-holders unless it is in the larger interest of the country..

The pattern of investment policy of the LIC until recently was governed by Section 27A of the Insurance Act, 1938 which was amended in April 1975. The following are the general guidelines relating to the investment policy of LIC:

1) The keynote of the corporation's investment policy is that it should invest its funds in such a manner as to safeguard and promote, to the maximum extent possible, the interest of the policy holders. The larger interest of the country should not however be ignored.
2) Investment should be dispersed over different classes of securities, industries and regions. The Corporation's policy has been not to acquire more than 30% of the outstanding equity shares of a compary.
3) The corporation should act purely as an investor. It should not assume the role of an operator or speculator in order to take advantage of temporary fluctuations in the market prices of securities.
4) The Corporation should underwrite security issues after a careful investigation of the project from financial, economic, technical, managerial and social angles.
5) The Corporation should review its investment portfolio from time to time and make such changes in its composition as may be warranted under the circumstances.
6) The Corporation should not acquire control of or participate in the management of any concern in which it has an interest as an investor, unless exceptional circumstances warrant such participation.

Investment Pattern

The'aggregate investible funds of LIC, comprising life insurance business and capital redemption insurance business increased from Rs. 17,318 crore in 1988 to Rs. 20,428 crore as at the end of March, 1989. Thus, in the year 1988-89 it recorded a rise of 18%. compared to 15.7% and 14.1% in the preceding two years.

Total outstanding investments of LIC (in Government and other approved securities, infrastructure facilities, assistance to industry, housing etc.) in March, 1989 aggregated to Rs. 18,702.3 crore, recording an increase of 17.2% over, that in the previous year. In March 1989 LIC's investments in Government and other approved securities and its direct assistance to industry constituted 49.2% and 13.2% of LIC's total investments.

The Corporation is authorised to assist the public sector undertakings and public limited companies by way of investment in their securities. The LIC subscribes to the share capital of companies, both preference and equity and also to bonds and debentures. It underwrites shares and debenrures but it does not guarantee deferred payments or loans as in the case of other financial institutions.

As shown in Table 10.1, LIC's direct assistance, to industry hy way of loans and underwriting direct subscriptions to shares and debentures sharply rose from Rs. 362.7 crore in 1987-88 to Rs. 660.2 crore in 1988-89. Sanctions by way of term loans increased from Rs. 127.2 crore in 1987-88 to Rs. 325.7 crore in 1988-89. Assistance sanctioned by way of underwriting/direct subscriptions increased by 42% during 1988-89 as against a decline of 20.6% registered in the previous year. Disbursement of direct assistance to industry, which had registered a decline (Rs. 342.3 crore) in the previous year, recorded an increase (Rs. 442 crore) during. 1988-89.

Table 10.1 Assistance Sanctioned and Disbursed

(Rs. in crores)

Year	Sanctions	Growth Rate %	Disburse-ments	Growth Rate %
1964-65	15.0	—	11.5	—
1970-71	17.8	—	8.1	—
1971-72	23.1	29.8	5.3	(-) 34.6
1972-73	20.1	(-) 13.0	14.0	164.1
1973-74	25.9	28.9	20.0	42.9
1974-75	43.8	69.1	54.1	170.5
1975-76	61.0	39.3	27.5	(-) 49.2
1976-77	57.1	(-) 6.4	38.9	41.5
1977-78	52.7	(-) 7.7	42.8	10.0
1978-79	65.5	24.3	31.7	(-) 25.9
1979-80	80.0	22.1	70.9	123.7
1980-81	70.0	(-) 12.5	65.5	(-) 7.5
1981-82	165.5	136.4	135.9	107.2
1982-83	136.5	(-) 17.5	86.6	(-) 36.3
1983-84	166.8	22.2	140.9	62.7
1984-85	219.9	31.8	161.5	14.6
1985-86	383.6	74.4	261.9	62.2
1986-87	363.8	(-) 5.2	389.8	48.8
1987-88	362.7	(-) 0.3	342.3	(-) 12.2
1988-89	660.2	82.0	442.0	29.1
Cumulative upto March 1989	3067.7		2413.6	

Source: IDBI, Report on Development Banking in India 1988-89

Aggregated assistance sanctioned by LIC; upto March 1989, totalled to Rs. 3,067.7 crore comprising term loans of Rs. 1,370.9 crore (44.7%) and underwritingldirect subscriptions of Rs. 1,696.8 crore (55.3%). Likewise, term loans and. underwritingldirect subscriptions constituted 45.2% and 54.8% respectively of the cumulative assistance disbursed upto March, 1989.

The chemicals and chemical product industry accounted for the highest share of 33.1% of direct assistance-sanctioned to industries, followed by basic metals (25.6%), textiles (14.4%) and machinery (9.7%). Assistance to chemicals and Chemical products, which was around Rs. 75 crore during the last three years, shot up to Rs. 218.6 crore during the year 1988-89, recording a growth of nearly three times. Among other major industries, assistance to basic metals increased by over two times and to textiles by nearly three times.

Assistance to machinery and electrical machinery increased by 51.7% and 51.5% respectively while assistance to the electricity generation industry witnessed a marginal decline of 0.4% as compared to the previous year. A little over two-thirds of the cumulative sanctions upto March, 1989, was accounted for by five industries viz.,

chemicals and chemical products (20.5%), machinery (15.7%), textiles (14%), basic metals (11.1%) and electricity generation (8.1%).

Now let us see the state-wise direct assistance given by LIC. Kerala State recorded maximum growth of 26 times in assistance sanctioned and its share increased from 0.08% in 1987-88 to 1.2% during 1988-89. Rajasthan and Madhya Pradesh registered appreciable increase of about 15 and 11 times respectively in assistance sanctioned and their respective shares increased'to 5.7% and 10.2% during 1988-89 from 0.7% and 1.7% in 1987-88. Assistance to Goa rose by four times; while assistance to Assam and Orissa almost doubled. Andhra Pradesh received maximum assistance sanctioned by LIC at Rs. 184 crore followed by Gujarat (Rs. 166.2 crore) their respective shares increasing to 27.9% and 25.2% in 1988-89. Thus, sanctions to these two states alone constituted more than half the total assistance sanctioned by LIC during 1988-89.

Assistance sanctioned to Bihar and Tamil Nadu declined in 1988-89 compared with 1987-88. Since from the inception, Maharashtra accounted for the highest share in sanctions (22.2%), followed by Gujarat (17%), Andhra Pradesh (10.4%), and Tamil Nadu (8.5%). Similarly, in 1988-89 in cumulative disbursements also Maharashtra secured the first position with 20.7%, followed by Gujarat (15.7%), Andhra Pradesh (12%), Tamil Nadu (8.6%) and West Bengal (8.4%).

LIC's assistance to backward areas has not been substantial and it does not also grant loans on concessional terms. It, however, participates in extending assistance to such units on normal terms. LIC's sanctions to backward areas rose from Rs. 37.3 crore in 1987-88 to Rs. 71.6 crore in 1988-89. Of backward areas in total sanctions marginally improved to 10.8% during 1988-89 from 10.4% in 1987-88. Orissa, which had not received any assistance for its backward areas in 1987-88, was sanctioned Rs. 5.3 crore in 1988-89. Maharashtra received the maximum assistance of Rs. 22 crore, accounting for 30.7% share in the total assistance sanctioned to backward areas during 1988-89, followed by Gujarat (17.2%) and Tamil Nadu (11.2%).

If we analyse the sector-wise assistance, the Corporation invested major portion of its resources in public scctor. The investment in public sector increased from Rs. 9,064 crore in 1986 to Rs. 14.032 crore in 1989 consisting of 80.9% of total invested funds. The investment in private corporate sector including joint sector accounted for 11.9% followed by cooperative sector 7.2%.

Evaluation **of** the Investment Policy

The LIC has achieved a major breakthrough in mobilising the savings of the people and building up a big reservoir for financing socio-economic schemes of national importance and the needs of public and private sector undertakings. The bulk of the corporation's investment is in the government securities and loans to socially oriented schemes and projects. Only a small proportion has gone to the financing of joint stock companies. Obviously, the public sector has claimed more than three-fourths of the Corporation's total assistance: while the balance (one-fourth) was shared by other sectors.

There has not been any significant diversification of the corporation's investment portfolio among different industries and regions. It has not extended its assistance to agricultural sector which is considered to be the backbone of Indian economy. **A** more realistic approach on the part of the LIC in investing its funds for industrial and agricultural sectors will help the country for a balanced economic growth in future.

The Corporation has been playing a pivotal role in the capital market since its formation. Although only a small share of the funds is used for financing the needs of private sector enterprises, the magnitude of the Corporation's resources is such that even this small proportion constitutes one of the largest single sources of industrial finance in the country.

In spite of its achievements, the investment policy of the Corporation has been the subject of controversy. It is said that LIC's contribution to the new industrial ventures is very limited. There is no doubt that the funds at the disposal of the Corporation arc the hard earned savings of the common man. So the corporation is not in a position take the risk of investing its funds in new industrial ventures. However, the LIC can help them by forming underwriting consortiums with other credit institutions and by

purchasing liberally the securities, shares and debentures of other financial institutions. It is said that the LIC has not played any significant role in social development projects like housing, drainage, water supply and other basic amenities.

Thus, the LIC occupies a unique position among the various financial institutions that constitute the Indian Capital Market. Because of its handling huge funds, the decisions of the Life Insurance Corporation exercise a decisive influence on the capital market, whether they relate to government bonds, industrial securities, or real estate.

10.4 GENERAL INSURANCE COMPANIES

The Government of India nationalised general insurance companies in India by taking over 107 general insurance companies. For managing these companies, it established General Insurance Corporation of India in 1973. The General Insurance Corporation of India (GICI) is a holding company having the following four subsidiaries.

1) National Insurance Company Ltd.
2) New India Assurance Company Ltd.
3) Oriental Fire and General Insurance Company Ltd.
4) United India Insurance Company Ltd.

Management

Management of the Corporation is vested in the hands of Board of Directors consisting of one Chairman and nine Directors including two Managing Directors. The registered office of the Corporation is located in Bombay.

Investment Policy

The main objective of the GICI's investment policy is to invest funds in socially oriented sectors of the economy. Such investments include Central and State Government securities, bonds, and debentures of public sector undertakings and also loans on soft terms to State Governments and other agencies engaged in housing and urban development. In addition to this the Corporation helps the industrial units by providing direct and indirect assistance.

GICI's investments in 1989 amounted to Rs. 3,409 crore. The investments in shares, debentures and term loans of companies went up in absolute terms to Rs. 1,115 crore registering a growth of 16.2% over the previous year. Study Table 10.2 carefully for the data relating to the financial assistance sanctions and disbursements by GICI and its subsidiaries.

As shown in Table 10.2, assistance sanctiqned by GICI and its four subsidiaries during the year 1988-89 to the industrial sector by way of term loans, underwriting/direct subscriptions to shares/debentures firm allotments and rights issue of sharesldebentures aggregated to Rs. 123 crore, recording an increase of 24.7% over the previous year.

Table 10.2 : Assistance Sanctioned and Disbursed

(Rs. in crores)

Year	Sanctions	Growth Rate %	Disburse-ments	Growth Rate %
1980-81	30.8	—	44.0	—
1981-82	50.I	62.7	33.7	(-) 23.4
1982-83	92.7	85.0	44.7	32.6
1983-84	108.5	17.0	84.5	89.0
1984-85	144.1	32.8	110.5	30.8
1985-86	153.0	6.2	107.3	(-) 2.9
1986-87	153.3	0.2	131.6	22.6
1987-88	98.3	(-) 35.9	103.5	(-) 21.4
1988-89	122.6	24.7	115.4	11.5
Cumulative upto March 1989	1097.3	—	857.9	

Source: IDBI, Report on Development Banking in India 1988-89

Industry-wise, fertiliser industry was the largest recipient of GICI's sanctions during the year, followed by textiles and machinery industries.

The analysis of GIC's state-wise assistance reveals that Maharashtra received major share during 1988-89 followed by Gujarat and Tamil Nadu. While coming to assistance to backward areas, in view of its primary concern for maintaining a sound and profitable investment portfolio, GIC has generally. refrained from participating in the grant of concessional assistance to backward areas.

On the whole GIC and its four subsidiaries are helping the nation in building a very. good base for the provision of general insurance facilities. While doing so it has been assisting the industrial sector financially in different ways. But it would be socially desirable if in future the GIC take more interest in providing finance for industries located in backward areas as instead of concentrating on the units located in industrially developed areas.

Check Your **Progress B**

1) In 1988-89 the LIC's share of investment to private corporate sector including the joint sector, the public sector and the cooperative sector were :
   i) private sector .....
   ii) public sector .....
   iii) cooperative sector. .....
2) State whether the following statements are **True** or **False.**
   i) The LIC is a holding company.
   ii) The LIC should invest in securities with an aim to speculate.
   iii) The interest, dividends, repayments and redemptions received by the LIC are a part of its investible resources.
   iv) The LIC must do a detailed scrutiny before underwriting a security issue.
   v) The LIC has treated both public and the private sector equally in its investment policy.

10.5 UNIT TRUST OF INDIA (UTI)

The Unit Trusts are quite popular in the western countries and they have made far greater progress than even genuine investment companies. This is particularly on account of certain advantages which the unit trusts enjoy over other forms of intermediation. The notable advantages of the unit trusts are:

1) Diversified portfolio or pooling of risks
2) Professional management
3) High degree of liquidity

A small investor on his own cannot avert risk if he directly makes investment in the shares and debentures of companies. With small resources to invest, he cannot have diversified portfolio. However, by making investment in the shares of unit trusts, risk is averted due to their investment policy. The unit trusts as a policy do not make concentrated investments in a few companies whatever be their financial position. In addition, they have the advantage of professional management. The redemption feature of units ensures high degree of liquidity. It is in fact this advantage which induces a large number of small savers to make investment in units.

Establishment of UTI : The importance of unit trusts in mobilising savings of small savers in India was recognised as early as 1931 by the Indian Central Banking Enquiry Committee. The need for setting up these trusts was stressed once again by the Shroff Committee in 1954. However, it was only in 1964 that the Unit Tryst of India was set up under the UTI Act, 1963. The UTI is an investment institution which offers the small investor a share in the India's industrial growth and productive investment with a minimum risk and reasonable returns.

The **Unit** Trust of India (UTI) is not a development bank. As the name itself suggests it is an investment trust. It falls in the category of financial institutions which collect savings of other economic units and lend them to those who wish to make productive use of them. Unit trust is comparable to Mutual Funds in the USA.

Objectives of UTI : The primary objective of UTI is to encourage and mobilise savings of the community. It channelises them into productive corporate investments so as to

promote the growth and diversification of the country's economy. Specifically, the objectives of the Trust are the following:

i) It mobilises the savings of the community and channelises them into productive investment. By promising savers the triple benefits of safety, liquidity and profitability of their investments, the Trust encourages individuals to save.
ii) It gives every one a chance to indirectly own shares and securities in a large number of select companies and enables the investors to share in the widening prosperity consequent on industrial growth.

Resources

Initial Capital : The initial capital of the UTI was statutorily fixed at Rs. 5 crore. It was to be contributed by the Reserve Bank of India (Rs. 2.5 crore), the Life insurance Corporation of lndia (Rs. 0.75 crore), the State Rank of lndia and its subsidiaries (Rs. *0.75* crore) and other financial institutions including banks (Rs. *1.0* crore). In 1976 the initial capital held by the Reserve Bank of lndia was transferred to the IDBI and thus the UTI became an associate institution of the latter.

Unit **Capita!** : The main source of the funds of the UTI is the unit capital which is raised from the sale of units to public under various schemes. The bulk of the funds obtained in this form are under the Unit Scheme, 1964 and Capital Gains Units Scheme, 1983. These two schemes presently account for more than two-thirds of the collections from the sale of units. The Unit Scheme, 1964 was the first scheme to be introduced by the UTI and has always been popular with the investors. The units sold under this scheme are of the face value of Rs. 10 each. However their market price is periodically determined and is higher than the face value. The basis for determining the market price of units under this scheme is the market valuation of the aggregate investments of the UTI over the previous period. The purchase price is kept lower than the sale price and between the two there has been always a margin of 30 paise or more.

Investment Policy : The investment policy of the UTI attempts to strike a balance between security of principal and return on capital. From the point of view of the security of capital, the securities in which investments are made must be of proven soundness and should be easily marketable. This implies that in the choice of securities safe andliquid securities should be preferred. Often these securities also ensure reasonable return on capital together with fair prospects of capital appreciation.

The UTI is not constrained like the LIC and banks to invest a certain proportion of its funds in government and other approved securities. It has the freedom to decide where it wants to invest its funds. However there are certain guidelines in this regard which suggest that the investment by the UTI in any one company should not exceed 5% of its (the UTI's) total investible funds or 15% of the value of the securities issued and outstanding of such a company. Moreover, investment in the initial issues of securities of new industrial undertakings should in any case be less than 5% of the UTI's total investible fund. The purpose of laying down these guiding principles for making investment by the UTI is to ensure that there is a reasonable amount of diversification of the investment portfolio.

Advantages to the Unit Molders

The investors derive the following advantages by investing in the units of Unit Trust of India.

1) Safety **of Investment** : The investment made in the units of UTI is quite safe. The UTI reinvests this money in wide range of securities covering risk and return. Hence the investors are assured safety for their investment.
2) Steady and Reasonable return on **Investment** : As per the statutory guidelines, the UTI has to distribute not less than 90% of its total income among the unit holders. It means that the unit holders are assured of a steady and reasonable rate of return on their investment.
3) Liquidity: The unit holders can easily convert their units into cash. The UTI repurchases the units anytime at the prices fixed by it. Further, the unit holders can transfer their units to third parties or can get loan from banks by putting units as security.

Working of UTI

The establishment of the UTI in 1964 may be said to be an important landmark in the development of capital market in India. The Trust played a crucial role for increasing

activity in new issues market and for the development of the secondary market for industrial securities in the country.

For the last 25 years, the UTI introduced many new schemes for channeling the savings of the people into productive sectors. The Trust so far introduced 22 schemes. All these schemes received tremendous response from public. Study Table 10.3 carefully for the highlights of the UTI's performance during the last five years.

Table 10.3: Unit Trust of India – Growth in Perspective

(Rs. in crores)

Indicators	1984-85	1985-86	1986-87	1987-88	1988-89
1) Sales under all Schemes	756.19	891.75	1261.06	2059.42	3855.01
2) Unit Capital	1757.30	2586.39	3726.11	5449.58	8905.11
3) Unit-holding Accounts (in lakhs)	17.01	20.38	29.79	38.56	48.56
4) Investible Funds	2209.61	3218.34	4563.68	6738.81	11834.65
5) Reserves and Provisions	299.87	445.08	567.18	940.72	2075.10
6) Gross Income	257.05	389.97	524.58	840.90	1687.02
7) Gross Expenditure	11.77	15.39	22.21	41.36	64.03
8) Income Distribution	214.92	316.79	427.86	682.68	1246.46
9) Sanctions	357.30	696.60	465.00	1024.80	1973.10
10) Disbursements	236.20	528.90	417.60	749.20	1091.20

Source: Annual Report of UTI, 1988-89.

It can be observed from the table that the sale of units by UTI under all schemes scaled a new peak (Rs. 3,701 crore) during 1988-89 recording significant growth of 79.7% over the previous years (Rs. 2,059 crore). The UTI added 9:2 lakh unit holder accounts in 1988-89 as compared to 8.9 lakh in the previous year, reflecting the growing popularity of its schemes,. The total number of unit holder accounts as at the end of June, 1989 was 47.8 fakh.

Investible funds: The total investible funds of UTI as on June 30, 1989 crossed Rs. 10,000 crore-mark for the first time, increasing to Rs. 10,859 crore from Rs. 6,739 crore as at the end of June, 1988 and registered an increase of 61.1%. Investments in the corporate sector in terms of equity/preference shares and term loans registered significant growth rates of 87.1% and 93.4% respectively. The trust invested a major portion of its income in the privately placed debentures (Rs. 1,790 crore).

Industry-wise and state-wise assistance: As shown in Table 10.4 the miscellaneous industry continued to be a largest recipient of UTI's assistance in 1988-89. The industry accounted for the highest share of Rs. 1,114 crore of the total cumulative assistance of Rs. 5,203 crore since the inception of UTI upto the end of March, 1989. The other industries which received assistance from the trust include machinery (Rs. 828 crore), basic metals (Rs. 329 crore), electricity generation (Rs. 458 crore) and services (Rs. 643 crore).

Table 10.4: Industry-wise Assistance Sanctioned

(Rs. in crores)

Industry	1986-87	1987-88	1988-89	Cumulative upto March, 1989
Textiles	66.7	59.9	90.0	448.0
Miscellaneous	78.1	298.9	387.5	1114.2
Chemicals, Basic Metal's	24.8	66.6	151.4	328.8
Machinery	50.1	29.8	336.3	828.3
Electricity Generation	39.1	150.0	170.3	458.6
Services	20.8	168.6	382.0	642.7
Total	465.0	1024.8	1973.1	5202.9

Source: IDBI, Report on Development Banking in India.

While coming to the state-wise assistance, as shown in Table 10.5, at the end of March, 1989 Maharashtra accounted for the highest share in assistance sanctioned (32.2%); followed by Uttar Pradesh (9.9%), Madhya Pradesh (9.5%), Gujarat (8.8%) and Andhra Pradesh (8.3%).

Table 10.5 : State-wise Assistance Sanctioned

(Rs. in crores)

State	1986-87	1987-88	1988-89	Cumulative up to March, 1989
Andhra Pradesh	10.9	31.1	314.0	432.9
Gujarat	47.9	90.1	137.2	458.4
Madhya Pradesh	1.2	161.2	241.5	492.2
Maharashtra	174.1	322.8	602.2	1675.3
Uttar Pradesh	39.8	134.9	255.1	513.1
Union Territories	24.9	22.8	136.8	244.5
	465.0	1024.8	1973.1	5202.9

Source: IDBI, Report on Development Banking in India, 1988-89.

During the year 1988-89, Public sector received Rs, 1,116 crore (56.6%) followed by Rs. 101 crore by the joint sector, Rs. 75 crore by the cooperative sector and Rs. 681 crore by the private sector.

On the other hand, the purpose wise assistance analysis reveals that the assistance sanctioned by the UTI to new projects registered almost four-fold increase to Rs. 233.4 crore from Rs. 62.7 crore in 1987-88, improving its share in total sanctions from 6.1% to 11.8% in 1988-89. Expansion/diversification schemes, which had received maximum assistance in the previous year, recorded a decline of 9.3% (Rs. 416.6 crore) in 1988-89 their share in total sanctions also fell from 44.8% to 21.1%. Share of modernisation rehabilitation acquisition of balancing equipment, which was 10% in 1987-88, declined to 3.3% (Rs. 65 during the year under review).

Though the UTI has shown remarkable progress from year to year for the last 27 years, the performance of the Trust has been criticised due to the following reasons:

I) Bias towards developed states: One of the important criticism on the working of the trust is that it is showing more bias in investing its funds in industrially developed states instead of helping the backward regions. But this argument is not true as the UTI has to invest its funds in industrial securities taking into account safety of unit holders funds followed by the necessity to provide stable return to them.

2) Urban bias: Another criticism is that the Trust is concentrating its activities more in urban areas while the rural masses are denied the advantage of sharing the industrial prosperity of the country. In the recent past the trust is trying to mobilise even rural savings but still there is so much to be done in this respect. There is no denying the fact that the Trust has not been able to provide any savings schemes particularly suited to the needs of different types of investors from rural areas.

3) Conservative investment Policy : The Trust follows a conservative investment policy in deciding investment matters. More than half of its investments are in fixed income-bearing securities which offer very limited scope for capital appreciation, In future the trust needs to show more dynamism in this matter.

4) High maintenance expenditure : The maintenance expenditure of the Trust is increasing many fold from year to year. The expenditure is well over 10% of its income. Considering that the trust distributed 90% of its income among the unit holders, there is little amount left for investment or for adding to its reserves.

5) Return is not high : The rate of dividend given by the trust to its unit holders is not high. No doubt, it has gradually stepped up its dividend rate; but the dividend paid out by the UTI does not compare favourably with the return on equivalent risk investments in other companies. The trust might have attracted more savers if it had promised a competitive dividend rate.

6) **Future of UTI:** At present (31rst March, 1989) the Trust has 48.56 lakh unit holders who are spread throughout the length and breadth of the country covering each nook and corner. It is hoped that the trust continues to experience rapid growth and is destined to make an important contribution to the Indian economy and in particular to the capital market. But its success in future depends upon its capacity in mobilising the rural savings and efficient service to the unit holders.

10.6 OTHER NON-BANKING FINANCIAL INSTITUTIONS IN INDIA

In addition to LIC, GIC, UTI there are a number of other non-banking financial institutions in India. They are:

I) Hire purchase finance Companies;
2) Investment Companies;
3) House Finance Companies;
4) Finance Corporations;
5) Mutual benefit Financial Companies; and
6) Chit Fund Companies etc.

These non-banking financial institutions are partly in organised sector and partly in unorganised sector. They may also be divided into non-banking financial companies and non-banking non-financial companies. While the former category includes hire purchase companies, investment companies, finance corporations, etc., the latter category covers all industrial and trading companies including companies which are non-financial and miscellaneous non-banking companies such as Chit Fund companies. These institutions solicit deposits both for short-term and medium-term from the public. Generally these institutions do not accept demand deposits.

The other non-banking financial institutions are also playing a crucial role in the economic development of the country. They are mobilising good amount of resources both from urban and rural savers. Though statistical data are not available, their contribution for economic development cannot be underestimated.

Owing to the absence of regulating mechanism by the RBI and other government agencies, they are able to exploit innocent public. They offer very high rates of interest and after grabbing good amount of money, they disappear from the scene making the investors to suffer.

It is high time that the RBI and government stopped the exploitation of hard earned sources by bringing these institutions under regulatory framework.

Check Your **Progress** C

1) What are the sources of investible funds of the UTI?

.....

.....

2) State whether the following statements are True or False:
   i) The UTI is like mutual funds in Western countries.
   ii) The main source of funds of the UTI is the government.
   iii) The UTI tries to choose safe and liquid securities.
   iv) Till 1988-89, the UTI has introduced 12 different schemes.
   v) More than half of the investments of the UTI are in fixed income-bearing securities.

10.7 LET US SUM UP

Financial intermediaries bring together the suppliers and demanders of financial resources. These include commercial banks, investment trusts, insurance companies, share brokers, hire purchase companies, etc. Except commercial banks, all other institutions mentioned above fall under the category of non-bank financial institutions.

Non-bank financial institutions help the individual investors by providing them steady returns with capital appreciation. These institutions provide funds to business and industry in backward areas at softer terms and reasonal cost. Moreover, these non-bank financial institutions also provide technical and managerial consultancy.

The Life Insurance Corporation was constituted under the LIC Act, 1956 as a wholly-owned government organisation. Its main objectives include spreading the message of life insurance to every corner of India, to conduct the business of life insurance to the best advantage of the society and to channelise the accumulated public savings in accordance with the economic policy of the nation. While investing funds the LIC takes into account several considerations like safety of funds, diversification of investment portfolio, time of maturity of the securities, etc.

Since inception the investible funds of the LIC have been continuously growing. During 1988-89 it grew at 18% and stood at Rs. 20,428 crore. Out of its resources, maximum investment flows to the government and other approved securities — its share in the total investment being 49.2% in 1988-89. The chemicals and chemical product industry was sanctioned maximum direct assistance (33.1%) followed by basic metal (14.4%) and textiles (9.7%). During 1988-89, Andhra Pradesh and Gujarat together were sanctioned more than half of the total sanctioned investment.

The LIC has succeeded in mobilising large amounts of savings of the people, but it has not been successful in 'diversifying its investment protfolio, region-wise or industry-wise. Its contribution to new industrial ventures and to the agricultural sector is very limited.

GICI is a holding company with four subsidiaries. It invests funds in socially oriented sectors of the economy which include government securities, and agencies engaged in housing and urban activities. During 1988-89, fertiliser industry was sanctioned maximum funds, followed by textile industry. GICI has not provided any concessional financial assistance to backward areas. However, GICI has helped in building up a good network of general insurance facilities.

The UTI is an investment Trust set up in 1964. Its main objective is to channelise the surplus funds of the community into productive use so as to achieve growth and diversification of Indian economy. The investment policy of the UTI aims at striking a reasonable balance between security. and return on investment. Unlike the LIC and commercial banks, the UTI is not constrained to invest any proportion of its funds in government and other approved securities. The UTI has come up with many schemes over time to tap resources from every segment of society. Its investible funds have crossed Rs. 10,000 crore in 1989, It-has been observed that the UTI has preferred to invest its funds in developed areas. A criticism of the UTI is that a major part of investible funds have flowed into urban areas. For the UTI, there is definitely a need and scope for developing new schemes to mobilise rural savings and to indentify rural industries to get financial assistance. Further there is also scope to reduce expenditure of the UTI and raise dividend to unit holders.

10.8 KEY WORDS

Mutual Fund : A company without issued capital stock owned by those members that do business with it. The profits of a mutual fund (net of reserves) are shared by its members.

10.9 ANSWERS TO CHECK YOUR PROGRESS

A 1) Investment trusts; development banks; Other institutions mainly undertake promotional activities and provide services to entrepreneurs.
2) i) True ii) False iii) False iv) True v) True

B 1) i) 11.9% n) 80.9% iii) 7.2%
2) i) False ii) False iii) True iv) True v) False vi) True

C 1) ,Initial capital, unit capital,
2) i) True ii) False iii) True iv) True v) False vi) True.

10.10 TERMINAL QUESTIONS

1) What is a non-bank financial intermediary? What are its features?
2) Discuss the role of the LIC in mobilising savings and helping in the fulfilment of national economic objectives.
3) The UTI has brought professionalism to the non-bank financial intermediation sector in India. Comment.
4) Write a short note on General Insurance Corporation of India.

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.

UNIT 11 TERM-LENDING FINANCIAL INSTITUTIONS — ALL INDIA LEVEL

Structure

11.0 OBJECTIVES

Alter studying this unit, you should be able to:

- describe the meaning, functions and objectives of development banks
- discuss the origin of development banks in India
- explain the working of all India level development banks
- assess the performance and prospects of developmcnt banks in India.

11.1 INTRODUCTION

In the previous unit you have been introduced to the role of non-bank financial institutions in India in linking the savers and users of capital. In particular, you have been exposed to the growth, working and problems of various non-bank financial institutions including Life Insurance Corporation of India, General Insurance Corporation of India, Unit Trust of India and other non-bank financial institutions. In this unit you will study the meaning, importance and evolution of development banks, role, functions and performance of various national level development banks in India.

11.2 WHAT IS A DEVELOPMENT BANK ?

Development banks are special financial institutions established for the supply of three basic ingredients of development : 1) capital, 2) knowledge, and 3) entrepreneurship to the industry. They have been set up during the post World War II period in both developed and underdeveloped countries. They are designed as a catalyst for quickening industrial development. In an underdeveloped country, where there is scarcity of capital and dearth of entrepreneurship, a set of banks which do not restrict their activity to the conventional function of providing term capital to the entrepreneurs are needed.

These banks should also assume a promotional role by undertaking potential industrial surveys, identifying growth projects, and providing technical, managerial and other assistance to interested entrepreneurs right from the stage of project

formulation to the commissioning and operation of the project. Thus, emerged the concept of development banks.

According to William Diamond *'a development bank is a hybrid institution which combines in itself the functions of a finance corporation and a development corporation.'* A finance corporation is an institution which is concerned primarily with long-term loancapital, while a development corporation is concerned primarily with equity capital and with fostering and managing specific companies as well as providing financial support.

Thus, development bank is a financial agency engaged in providing medium and long-term assistance to industrial undertakings in the form of loans. It guarantees loans in addition to undertaking of underwriting, and direct subscription to shares and debentures. It also provides technical know-how and training to entrepreneurs.

11.3 FUNCTIONS OF DEVELOPMENT BANKS

The following are the functions of development banks:

1) Sanction of loans : The important function of the most of the development banks is to provide long-term and medium term loans to industrial concerns. Certain development banks grant loans in foreign currencies also.
2) Guarantee of loans : They also provide guarantees for loans raised by business concerns from other sources. They extend guarantees for deferred payments for purchase of capital goods from abroad.
3) Underwriting of industrial securities : Another important function of development banks is to underwrite the issue of shares, bonds or debentures of industrial concerns.
4) Investment in shares and debentures : In addition to underwriting, the development banks also directly invest in industrial undertakings by subscribing to their shares and debentures.
5) Merchant banking : In the recent past some development banks have estdblished subsidiary companies, for undertaking various merchant banking activities.
6) Development functions : Special financial institutions not only act as term lending institutions but also as development banks. They formulate projects, conduct techno-economic surveys, provide training and consultancy to entrepreneurs, and improve management of industrial units.

11.4 ORIGIN OF DEVELOPMENT BANKS

Although the term 'Development bank' was used for the first time after the Second World War, similar type of institutions were in existence in the early part of the 19th Century in some countries. The first development bank, known as Societe Generale de Belgique, was established in Belgium to finance commercial and industrial ventures. However, its activities did not arouse much interest. In 1852 French Credit Mobiliser was established. Later it became a model for similar investment banks in Germany, Austria, Belgium, the Netherlands, Italy, Switzerland and Spain.

The post-Depression period witnessed the second phase of development banks during which the need to cater for small-scale industries was recognised. Accordingly, special financial institutions were formed in several countries.

In India, the first step towards building up a structure of development finance institutions was taken with the establishment of the Industrial Finance Corporation of India (IFCI) in 1948. The IFCI was established to provide medium and long-term credit to units in the corporate sector and industrial co-operatives. A set of parallel financial institutions, known as the State Financial Corporations (SFCs), were set up at the State level in 1951 to extend the benefits of long-term loans to medium and small sized industrial undertakings in the respective states. The Industrial Credit and Investment Corporation of India (ICICI) was set up at all India level in 1955 as a joint stock company with support from the Government of India, the World Bank, the Commonwealth Development Finance Corporation and other foreign institutions'

to finance the foreign exchange components of industrial projects particularly in, private sector.

State level institutions, namely the State Industrial Development Corporations (SIDCs) were established in the 1960s mainly for promoting medium scale industrial units. The State Small Industries Development Corporations were also established at state level during sixties for catering to the requirements of small scale units. For co-ordinating all the development banks at the national and the State levels, the Government of lndia established an apex institution known As lndustrial Development Bank of lndia (IDBI) in 1964. The Government of India in 1990 established Small Industries Development Bank of lndia (SIDBI) as an apex Bank to meet the needs of small scale units exclusively.

Thus many development banks were set up in India both at the national and state levels.

Let us now discuss the functions and working of the various national level development banks in India (their state level counterparts are discussed in Unit 12).

Check Your Progress A

1) Which of the following statements are True and which are False?
   i) Development banks help in accelerating industrial growth.
   ii) Development banks provide medium and short-term financial assistance to industry.
   iii) Industrial undertakings raising loans from sources other than the devcloprnent banks can avail of the facility of guarantee of the loan by these development banks.
   iv) Development banks can directly subscribe to the shares and debentures of industrial units.
   v) Industrial Development Bank of India was the first development bank in India.
2) Fill in the Blanks :
   i) Societe Generale de Belgigue was the .....development bank in the world.
   ii) Development banks extend guarantees for ..... payments for purchase of capital goods from .....
   iii) Development banks provide three basic components of development of industry. They are..... ,..... and .....

11.5 INDUSTRIAL FINANCE CORPORATION OF INDIA (IFCI)

Industrial Finance Corporation of India (IFCI) is the first development Bank established in India. It was established in July, 1948 through a Special Act of the Parliament for providing long-term financial assistance to large and medium scale undertakings.

Objectives

The primary object of the formation of this Corporation was to make medium and long-term credit facilities easily available to the industrial concerns especially in the areas, where normal banking facilities are inappropriate or recourse to capital issue method is impracticable. It provides financial assistance to those companies or Co-operative societies that have been registered in the country and are concerned with manufacturing, mining, shipping, hotel etc. It does not provide finance to small scale industries and unregistered companies.

Sources of Funds

Its authorised capital is Rs. 250 crore. As on 31st March, 1990, its paid-up capital was Rs. 100 crore. lndustrial Development Bank of India owns 50% of its paid-up capital and the balance by scheduled banks, cooperative banks, Insurance Corporations, Investment Trusts, etc. In addition, it borrows from market through bonds, gets loans from Central Government and obtains foreign credits.

Management and Organisation

Industrial Finance Corporation of India (IFCI) is managed by a Board of Directors, which consists of partly elected and partly nominated directors. The Central Government appoints the whole-time Chairman of the Board in consultation with the Industrial Development Bank of India (IDBI). The Board consists of the following:

One Chairman	—	appointed by the Central Government
Two Directors	—	nominated by the Central Government
One Director	—	nominated by the Reserve Bank of India
Three Directors	—	nominated by Industrial Development Bank of India
Two Directors.	—	elected by Insurance Concerns, Investment Trusts, etc.
Two Directors	—	elected by Co-operative Banks.

Functions

Following are the important functions of Industrial Finance Corporation of India:

1) Granting loans and advances to industrial concerns and subscribing to debentures floated by them which are repayable within 25 years.
2) Guaranteeing the loans raised by industrial concerns in the open market or from scheduled banks and cooperative banks.
3) Underwriting the issue of shares, debentures and bonds by industrial concerns. But it is required to dispose of these securities within 7 years.
4) Granting loans to industrial concerns.
5) Guaranteeing loans in foreign currency raised by industrial concerns from any bank or institution in a foreign country. However, prior approval of the Central Government is required for this purpose.
6) Acting as an agent for the Central Government and for the World Bank with regard to loans sanctioned by them to industrial concerns in India.
7) Guaranteeing credit purchase of capital goods from foreign manufacturers. With the approval of the Central Government, the IFCI can guarantee the loans raised in foreign currency from foreign institutions.
8) Subscribing directly to the shares issued by industrial concerns.
9) Providing assistance under the soft loan scheme to selected industries such as cement, cotton textiles, jute, engineering, etc., to expedite modernisation, replacement and renovation of their plant and machinery.
10) The IFCI has been undertaking various promotional activities financed out of its benevolent Reserve Fund and allocations of Interest Differential Funds received from the Government. The corporation has been emphasising the development of backward areas and the helping and the developing of small and medium scale industrial entrepreneurs. It has been providing them with the needed guidance for the establishment and management of these units,

Performance

Industrial Finance Corporation of India had completed 42 years by June, 1990. During this period it acted as a pioneer in the provision of industrial finance.

It sanctioned financial assistance to various enterprises of national importance. The assistance sanctioned by the corporation since 1970-71 till recently can be observed from Table 11.1

During the 42 years of its existence, the corporation had sanctioned a net total financial assistance of Rs. 6,570 crore and disbursed Rs. 4,295 crore. In the recent past, the sanctions and disbursements of the corporation increased substantially. During 1988-89 itself it sanctioned Rs. 1,005 crore. This itself shows the increasing importance of the Corporation in the provision of industrial finance in India.

The assistance given by the Corporation in the early years of its establishment mainly confined to traditional industries like sugar, textiles, jute, etc. But subsequently, in pursuance of the national priorities and objectives, it has extended considerable assistance in recent years to non-traditional industries like basic metals, fertilisers, chemicals and a wide range of engineering industries. During 1988-89, the maximum assistance was sanctioned to the fertiliser industry (Rs. 238 crore) followed by the basic metals (Rs. 161 crore), cement (Rs. 144 crore), electrical machinery (Rs. 134 crore), food products (Rs. 133 crore) and textile industries (Rs. 126 crore). These six industries together accounted for almost half of the total sanctions.

There is a little controversy on the performance of Industrial Finance Corporation of India. If we see the growth of capital, financial assistance sanctioned and disbursed

Table 11.1 :,Assistance Sanctioned and Disbursed by IFCI

(Rp. in crores)

Year	Sanctions	Growth rate %	Disbursements	Growth rate %
1970-71	32.3		17.4	
1971-72	28.7	(-) 11.1	23.3	33.9
1972-73	45.7	59.2	28.0	- 20.2
1973-74	41.9	(-) 8.3	31.9	13.9
1974-75	29.2	(-) 30.3	37.0	16.0
1975-76	51.3	75.7	34.7	(-) 6.2
1976-77	76.6	49.3	54.9	58.2
1977-78	113.4	48.0	57.5	4.7
1978-79	138.5	22.1	73.5	27.8
1979-80	137.9	(-) 0.4	91.0	23.8
1980-81	206.6	49.8	108.9	19.7
1981-82	218.1	5.6	169.4	55.6
1982-83	230.2	5.5	196.1	15.8
1983-84	321.9	39.8	224.5	14.5
1984-85	415.4	29.0	272.9	21.6
1985-86	499.2	20.2	403.9	48.0
1986-87	798.0	59.9	451.6	11.8
1987-88	1025.1	28.5	660.0	46.1
1988-89	1095.6	85.9	1005.3	52.3
Cumulative upto March 1989	6569.8		4295.3	—

Source : IDBI, Report on Development Banking in India, 1988-89, p. 22.

and also its profits, its performance is impressive. But we get a different picture when we go deep into its operations. Many criticised the working of the corporation on the following grounds.

1) Despite the fact that the assistance to the backward regions has shown a remarkable increase in recent years, a sizeable portion of this assistance has been confined'to the backward projects of developed states. It is difficult to justify financial assistance to underdeveloped 'areas in developed states like Maharashtra, Gujarat, etc., on par with the ones located in backward states like Assam, Orissa, Kerala, Rajasthan, Madhya Pradesh, etc.
2) Another criticism on the working of the Corporation is that it offered financial assistance to big concerns which could easily raise resources from the capital market.
3) It is failing in exercising its control over defaulting borrowers.

11.6 INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF INDIA (ICICI)

Industrial Credit and lnvestment Corporation of India (ICICI) was the second all-India level financial institution to be established in India. It was established in January 1955. Unlike other development banks in India, this is a privately owned and operated corporation. The World Bank played a crucial role in the establishment of this corporation.

Objectives

The following are the objectives of the Corporation.

I) To provide financial resources to industrial concerns for their promotion, development and modernisation.
2) To encourag:: .nflow and participation of foreign capital in the private sector units.
3) To encourage private ownership in industrial investment and to increase the scope of investment market.

Resources

The authorised capital of ICICI is Rs. 200 crore. The issued capital of ICICI as on March 31, 1990 was Rs.91.56 crore. Borrowings constitute a major source for ICICI.

Its borrowings included those from the Government of India, the world Bank, the Development Loan Fund (now merged with the Agency for International Development), ereditanstaltfur-Wiederaufbau (an agency of the Government ot Federal Republic of Germany), the British Government and Industrial Development Bank of India.

Management

Ownership and management of ICICI is vested in the hands of a Board of Directors consisting 12 directors. The Chairman and a managing director will be appointed by Government of India after consulting Industrial Development Bank of India.

Types of Assistance

The following are the various types of financial assistance available from ICICI.

1) It provides loans repayable over a period of 15 years.
2) It provides finance through equity participation,
3) It sponsors and underwrites new issues of shares and other securities.
4) It makes funds available for investment by revolving investment as quickly as possible.
5) It guarantees loans from private investment sources.
6) It provides loans in foreign currency to import capital equipment.
7) It furnishes managerial, technical and administrative services to the industry.
8) It undertakes promotional activities with a view to fostering growth in the backward areas.

Performance

ICICI is the only Corporation which specialises in securing assistance for industrial securities from abroad. It is helping in a significant way for setting up of industrial units in private sector. During the last 35 years its financial assistance to the private corporate sector was substantial. As shown in Table 11.2, the cumulative financial assistance sanctioned by the Corporation upto March 31, 1989 amounted to Rs. 9,313

Table 11.2 : Assistance Sanctioned and Disbursed by ICICI

(Rs. in crores)

Year	Sanctions	Growth Rate %	Disbursements	Growth Rate %
1970-71	43.9	—	28.9	
1971-72	39.7	9.6	30.3	4.8
1972-73	49.4	24.4	39.7	31.0
1973-74	61.1	23.7	43.5	9.6
1974-75	62.9	2.9	45.4	4.4
1975-76	78.6	25.0	61.1	34.6
1976-77	98.7	25.0	67.3	10.1
1977-78	108.3	9.7	91.6	36.1
1978-79	182.8	68.8	109.2	19.2
1979-80	204.3	11.8	135.8	24.4
1980-81	314.1	53.7	185.3	36.5
1981-82	302.4	(-) 3.7	264.7	42.8
1982-83	392.1	29.7	282.2	6.6
1983-84	507.6	29.5	334.2	18.4
1984-85	620.7	22.3	392.7	17.5
1985-86	708.2	14.1	482.2	22.8
1986-87	1118.3	57.9	695.5	44.2
1987-88	1283.3	14.8	771.2	10.9
1988-89	2056.1	60.2	1085.6	40.8
Cumulative upto March 1989	9313.3	—	6445.0	—

Source : IDBI, Report on Development Banking in India, 1988-89, p. 28.

crore and disbursements to Rs. 6,445 crore. In the recent past, the corporation substantially increased its assistance. It sanctioned Rs. 2,056 crore and disbursed Rs. 1,085 crore during 1988-89 itself.

Of the total sanctions of Rs. 2,056 crore during 1988-89, rupee loans amounted to Rs. 1,400 crore followed by Rs. 539 crore in foreign currency loans, Rs. 19 crore for underwriting and direct subscription and Rs. 7.9 crore for guarantees.

The major recipients of the financial assistance from the corporation are the non-traditional industries, such as chemicals, petro-chemicals, heavy engineering and metal products. While coming to the state-wise assistance, Maharashtra, Gujarat, Uttar Pradesh, Tamil Nadu and Andhra Pradesh received substantial assistance from this institution. However, in the recent past, the assistance to underdeveloped states like Orissa, Mimachal Pradesh, etc., increased substantially.

During the year 1988-89, new projects continued to receive maximum assistance. But assistance to expansion/diversification schemes recorded the highest growth. While coming to the sector-wise analysis, the private sector received maximum assistance (84%) followed by joint sector (12.9%), cooperative sector (2.3%) and public sector (0.9%)

ICICI had been playing a very important role in providing financial assistance to the industrial units particularly in private sector. Its pioneering work as the underwriting institution in this country has been widely acclaimed. The provision of foreign currency loans is another area where the corporation has distinguished itself.

Despite the above achievements, the working of the corporation has been criticised due to the following reasons:

1) The ICICI has been concentrating in providing financial assistance to a few industries like chemicals, textiles, cement, fertilisers, etc.
2) It is not working towards effectively balanced regional development of the country as per national priorities. For instance, of the cumulative financial assistance sanctioned upto the end of March, 1989, 23.4% went to Maharashtra followed by Gujarat (14.8%), Uttar Pradesh (9.8%), Tamil Nadu (8.7%), and Andhra Pradesh (8.1%). It means that around 65% of the total assistance sanctioned (Rs. 7,923 crore) by the Corporation since its inception went to these five developed States.
3) It has been assisting only larger units in private sector contrary to the policy of the Government.

Check Your Progress B

1) Fill in the blanks :
   i) Main objective of creation of IFCI was to provide ..... and ..... term financial assistance.
   ii) The IFCI acts as agent for the loans sanctioned by the .....government and the ....
   iii) The authorised capital of ICICI is Rs. ..... crore.
2) State whether the following statements are True or False.
   i) ICICI is the only corporation that specialises in securing financial assistance. for industrial securities from abroad.
   ii) The World Bank played a crucial role in the establishment of IFCI.
   iii) The financial assistance provided in the initial years of the establishment of ICICI mainly confined to traditional industries like sugar, jute, etc.
   iv) IFCI has financed to promotional activities from its Reserve Fund and Interest Differential Funds.
   v) IFCI has been providing soft loans for modernisation, replacement and renovation of plant and machinery.

11.7 INDUSTRIAL DEVELOPMENT BANK OF INDIA (IDBI)

Industrial Development Bank of India had come into existence in July 1964 by an Act of Parliament. This Bank was a wholly owned subsidiary of the Reserve Bank of India. Since 16th February. 1976. it has been delinked from the RBI and, made an autonomous corporation. This was done mainly to enlarge its role as an apex

financial institution to achieve effective coordination among all the financial institutions in the country.

Objectives

The principal objective of setting up the IDBI was to make a coordinated effort to achieve maximum industrial growth. The overall activities of the Bank may be classified into three broad categories namely, coordination, financing and promotion. The objectives of the bank are summarised below:

1) To serve as an apex institution for term finance for industry.
2) To coordinate working of institutions engaged in financing, promoting or developing industries and to assist the development of these institutions.
3) To provide term finance to industry.
4) To plan, promote and develop industries to fill gaps in the industrial structure of the country.
5) To provide technical and administrative assistance for promotion and expansion of industry.
6) To undertake market and investment research and surveys as also technical and economic studies in connection with the development of industry.
7) To act as lender of last resort to finance projects that are in conformity with national priorities.

Resources

As on March, 1989 its authorised capital was Rs. 1,000 crore, while its paid-up capital stood at Rs. 540 crore. Its reserves as on date accounted for Rs. 608 crore. Besides securing loans from RBI, Central Government, foreign sources, it also secured funds from internal capital market.

Management and Organisation

The management of the IDBI is vested in a Board of Directors consisting of 22 directors including a full-iime Chairman-cum-Managing Director appointed by the Central Government. The other Board members comprise a representative of the Reserve Bank of India, two officials of the Central Government, 5 representatives of financial institutions, 6 representatives of public sector'banks and SFCs, 2 employees of financial institutions, and 5 persons with special knowledge and professional experience, nominated by the Government of India.

The Board has constituted an Executive Committee consisting of ten directors including the Chairman and Managing Director. The Board of Directors deal with the overall policy matters and the Executive Committee deals with proposals for the sanction of financial assistance and other matters.

The central office of the bank is located in Bombay. It has five regional offices at Calcutta, Delhi, Madras, Bombay, and Ahmedabad. Besides these regional offices, the IDBI has eleven branches at Bangalore, Bhopal, Bhubaneswar, Chandigarh, Cochin, Hyderabad, Jaipur, Jammu, Kanpur, Patna and Simla.

Functions

The following are the functions of IDBI:

1) Direct financing : It provides direct financial assistance to industrial concerns by giving them long-term loans and advances.
2) Guaranteeing of loans : It guarantees loans raised by industrial concerns in the open market or from banks or other financial institutions.
3) Acceptance and discounting of bills : It accepts, discounts and rediscounts bills of exchange, promissory notes, hundis, etc., of industrial concerns.
4) Direct subscriptions and underwriting : It subscribes to shares, bonds, and debentures issued by industrial concerns. It also underwrites such issues.
5) Refinancing : It provides refinancing facilities to scheduled banks arid other financial institutions. Its refinances include: 1) loans between 3 to 25 years granted by IFCI, SFCs or any other financial institution, 2) loans between 3 to 10 years granted by a scheduled or a cooperative bank to any industrial concern, 3) export loans between 6 months to 10 yearagiven by a scheduled bank or a co-operative bank or any other financial institution.
6) Promotional activities : It provides and arranges technical and managerial assistance for an industrial concern (or person) for promotion, management or expansion of any industry. It is also entrusted with the responsibility of planning,

promoting and developing industries with a view to filling gaps in the industrial structure.

7) **Other functions** : It undertakes research and surveys in the fields of marketing and investment. It may establish subsidiaries to carry out its functions and undertake any business which the Central Government may ask it to undertake.

Performance

The Industrial Development Bank of India is the leading development bank of India. Its progress. if judged by its operations, has really been spectacular all through but more so during recent yea'rs. Let us now discuss the various activities of the bank under the following headings.

The total Financial assistance sanctioned and disbursed by fhe bank since its inception can be observed From Table.11.3. It can be seen from the table that the IDBI's cumulative assistance upto the end of March. 1989 reached to Rs.34,400 crore. During the same period the bank disbursed Rs. 25,112 crore. The assistance sanctioned and disbursed for the latest three years is significant. During 1988-89 it sanctioned Rs. 7,117 crore and disbursed Rs. 4,746 crore.

Industry-wise analysis of financial assistance sanctioned by IDBI reveals that the services industry received major (17%) share in cumulative assistance sanctioned upto March, 1989 followed by Textiles (12.8%), electricity generation (10.6%), miscellaneous chemicals (6.6%), fertilisers (6.6%), and food products (5.5%).

Table 11.3 : Assistance Sanctioned and Disbursed

(Rs. in crores)

Year	Sanctions	Growth rate %	Disbursements	Growth rate %
1964-65	28.6	—	20.7	—
1970-71	69.6	—	57.6	—
1971-72	148.9	113.9	80.1	39.1
1972-73	96.6	(-) 35.1	81.7	2.0
1973-74	167.0	72.9	137.0	67.7
1974-75	253.7	51.9	203.1'	48.2
1975-76	304.6	20.1	223.5	10.0
1976-77	539.6	77.1	341.4	52.8
1977-78	679.5	25.9	410.3	20.2
1978-79	724.8	6.7	618.1	50.6
1979-80	1131.9	56.2	752.9	218
1980-81	1291.2	14.1	1014.1	34.7
1981-82	1549.8	20.0	1217.9	20.1
1982-83	1800.2	16.2	1498.5	23.0
1983-84	2303.4	27.9	1774.3	18.4
1984-85	3342.0	45.1	2073.7	16.9
1985-86	3517.2	5.2	2783.9	34.2
1986-87	4427.0	25.9	3205.9	15.2
1987-88	4791.3	8.2	3613.6	12.7
1988-89	7117.6	48.6	4745.8	31.3
Cumulative upto March 1989	34400.4	—	25112.2	—

Source : IDBI, Report on Development Banking in India, 1988-89, P. 17.

A few developed States continued to receive major portion of the assistance sanctioned by the Bank. During 1989-90 Maharashtra (Rs. 737 crore), Gujarat (Rs. 845 crore), Tamil Nadu (Rs. 722 crore), Uttar Pradesh (Rs. 784 crore), Andhra Pradesh (Rs. 552 crore) and Rajasthan (Rs. 523 crore) received 60% of the total assistance sanctioned by IDBI. In fact, out of Rs. 32,942 crore cumulative assistance sanctioned, 61% went to these states only. However, in the recen past, the bank extended its assistance substantially to backward areas.

Assistance sanctioned to private sector projects accounted for three-fourths of the cumulative sanctions as at the end of March, 1989. Public enterprises, on the other

hand, received Rs. 5,797 crore followed by joint sector Rs. 1.895 crore and co-operative sector Rs. 675 crore.

The role of IDBI in Nation Development

As an apex bank, the IDBI has been playing a very important role in the nation building activities. Its contribution is noteworthy particularly from the following:

I) **Creation of more employment opportunities** : The Bank has given a big impetus to creation of employment opportunities in the country. As a result of the assistance given by it to the enterprises, about 84.7 lakh jobs were created so far since its inception.

2) **Assistance to weaker units :** It is specially helpful to industrial concerns which, for one reason or another, find it difficult to raise finance through normal channels.

3) **Development of small-scale units** : The Bank took special interest, for the development of small-scale sector in India until the establishment of Small Industry Development Bank of India in 1990. It played crucial role in the establishment of this apex level institution for solving the problems of small-scale sector.

4) **Assistance to new entrepreneurs** : In addition to the grant of finance on liberal terms, it has done a lot to discover and encourage new entrepreneurial talent in the country. It provided a wide variety of services to the new entrepreneurs in addition to training facilities.

5) **Sponsoring of technical consultancy organisations** : The bank has sponsored eight Technical Consultancy Organisations (TCOs) in different parts of the country. The TCOscater to the needs of new and small entrepreneurs in areas such as project identification, project formulation, market surveys and various reports. They also provide technical and managerial assistance. The TCOs are also making efforts to identify new entrepreneurs and provide training facilities to them.

6) **Development of backward regions** : The bank has channelled a substantial portion of its funds to industries established in backward regions. It is taking active role in correcting regional imbalances in the industrial development of the country.

7) **Soft loan scheme :** The Bank provided soft loans to industrial units in selected industries, namely Cotton textiles, Jute, Cement, Sugar and Engineering. Under the soft loan scheme the IDBI sanctions loans to industrial units of these industries to bring about the much neglected modernisation, replacement and renovation of plant and machinery.

8) **Coordination between term lending institutions** : It has brought about effective cooperation among the term-finance institutions in the country. The proposals for finance put up by industrial concerns are now jointly appraised, processed and financed. As a result, there is no overlapping of activities, risks are diversified, and financing is in tune with the national priorities.

Criticism

IDBI achieved tremendous growth in loan sanctions, disbursements, assistance to small sector, assistance to backward areas during the period between 1964-65 and 1988-89. However, if we look at the things closely, we notice certain gaps in the activities of IDBI.

1) **Fall in disbursements** : There was a steady growth in the loans sanctioned by IDBI in the 1980s. As against this, there was a declining trend in disbursements during the same period. For instance sanctions as a percentage of total was 56.0% in 1980-81 which increased to 62.4% by 1984-85 as against a decline from 44% to 37.5% in the case of disbursements during the same period.

2) **Inadequate care on the development of backward areas** : IDBI is criticised for its lenience towards backward areas of developed states than the backward states themselves. For instance, of its total assistance 46.8% was shared by four developed states, Maharashtra (13.5%), Gujarat (12.2%) Uttar Pradesh (11.0%) and Tamil Nadu (10.1%) by March, 1989. As against this, nine backward states received 2.4% only. Further, none of the backward states could get more than 1% in respect of percentage of total assistance of IDBI.'

3) **Urban culture** : Since its head office, regional offices and branch offices are at metropolitan cities and State Capitals, it developed elitist and urban culture.

4) Delay in disposal of applications : It is said that IDBI takes unduly long time in appraising and processing the applications for financial assistance received from industrial concerns.

5) No links with outside agencies : It has not made adequate efforts to establish close links with the outside agencies like Asian Development Bank, World Bank and other such International agencies.

11.8 OTHER DEVELOPMENT BANKING INSTITUTIONS

Besides IFCI, ICICI and IDBI, there are some other development banking institutions at national level. They are Industrial Reconstruction Bank of India and Small Industries Development Bank of India. Now let us discuss about these two institutions in detail.

11.8.1 Industrial Reconstruction Bank of India (IRBI)

The Industrial Reconstruction Bank of India (IRBI) was established as a statutory corporation on 20th March, 1985 to take over the operations of the Industrial Reconstruction Corporation of India (IRCI). Its main objective is to function as the principal credit and reconstruction agency for the revival of sick industries. Another important objective is to bring coordination among various agencies working for the revival of such units. Its management is vested in the hands of Board of Directors with one Chairman and Managing Director and 12 directors. All of them are appointed by Government of India. Its authorised capital was Rs. 200 crore, while its paid up capital was Rs. 98 crore as on June 1988. It has the privilege to receive interest free loans from Central Government to the tune of Rs. 80 crore every year. It can also raise foreign loans guaranteed by Government of India.

The following are the functions of IRBI:

1) It can take over the management of sick industrial units, lease them out, sell them as running concerns or prepare schemes for reconstruction by scaling down the liabilities.
2) It can also assist and promote industrial development by granting loans and advances and also by subscription and underwriting of shares and debentures.
3) Its range of activities also includes services like provision of infrastructure facilities, consultancy, managerial and merchant banking activities.

Performance

It sanctioned Rs. 208.7 crore during 1988-89 as against its disbursements of Rs. 116.5 crore. As shown in Table 11.4, till June, 1988 it assisted 535 units with Rs. 522 crore. If we take industry-wise, cotton textiles (14.8%) received a major share of funds, followed by paper and paper products (6.1%) and Steel (5.6%). West Bengal (Rs. 219 crore) stood first in receiving financial assistance disbursed from IRBI, followed by Maharashtra (Rs. 55 crore) and Gujarat (Rs, 50 crore) by June, 1988.

By June 1988, of the total 535 units assisted by IRBI, production of 257 units accounted for Rs. 6,362 crore and sales Rs. 6,450 crore. Thus, it has rendered a lot in remaining the sick units.

Table 11.4 Loan Sanctions and Disbursements of IRBI

(Rs. in crores)

year	Sanctions	Disbursements
1986-87	148.9	94.6
1987-88	186.5	101.9
1988-89	208.8	116.5
Cumulative Total till 31.3.1989	912.2	624.1

Source : IDBI, Report on Development Banking in India, 1988-89.

Inspite of its **contributions,** IRBI is also being criticised because of the following reasons :

i) It was alleged that the assistance is given only to a set of selected industries like engineering and textiles. Nearly two-thirds of IRBI's assistance was taken away by these industries.

ii) There was a wide gap between sanctions and disbursements. On average, only 55% of the loans sanctioned were being disbursed.

iii) It is considering only a fraction of the total applications. Hence many applications are pending unsettled.

11.8.2 Small Industries Development Bank of India (SIDBI)

Small Industries Development Bank of India (SIDBI) was set up as a wholly-owned subsidiary of IDBI under the Small Industries Development Bank of India Act, 1990. It is the principal financial institution for promotion, financing and development of small-scale industries. It is also expected to co-ordinate the functions of existing institutions engaged in similar activities. SIDBI commenced its operations on April 2, 1990 and has takenover from IDBI the responsibility of administering the Small Industries Development Fund and the National Equity Fund.

11.9 EVALUATION OF DEVELOPMENT BANKS IN INDIA

All India financial institutions (AIFIs) viz., IDBI, IFCI, ICICI, LIC, GIC and UTI have made rapid progress in their operations in recent years. Over the years, AIFIs have emerged as major catalysts for channelising development finance to industry and related sectors. New and innovative schemes have been devised.

The data relating to sanctions and disbursements made by all financial institutions in India is presented in Table 11.5. It can be seen from the table that the aggregate sanctions and disbursements of loans by development banks had witnessed a steaay increase over the years. During the period 1948-64, aggregate assistance sanctioned by them was to the order of Rs. 458 crore. Assistance sanctioned increased from Rs. 118 crore in 1964-65 to Rs. 177 crore during 1969-70. Particularly there was a spectacular growth in their sanctions and disbursements during the 1980s. Thus, loans sanctioned had touched Rs. 13.722 crore during 1988-89. Their cumulative sanctions till March 1989 accounted for Rs. 59,104 crore. Same trend is noticed in respect of their disbursements also. Thus, their disbursements which stood at Rs. 91 crorr in 1964-65, shot up to Rs. 8,375 crore during 1988-89. Their cumulative disbursements till March. 1989 were to the order of Rs. 42.112 crore.

Table 11.5 : Assistance Sanctioned and Disbursed by **AIFIs**

(Rs. in crores)

Year	Sanctions	Growth Rate %	Disbursements	Growth Rate %
1980-81	2293.5	—	1599.6	—
1981-82	2367.1	3.2	1826.2	14.2
1982-83	2907.2	22.8	2152.2	17.9
1983-84	3721.4	28.0	2687.3	24.9
1984-85	5031.9	35.2	3180.1	18.3
1985-86	5942.9	18.1	4552.9	43.2
1986-87	7237.6	21.8	5204.0	14.3
1987-88	8579.3	18.5	6233.5-	19.8
1988-89	13722.8	60.0	8375.3	34.4
Cumulative upto March 1989	59103.8	—	421 12.5	—

Source : IDBI, Report on Development **Banking** in India, 1988-89 p.11.

critical.Appraisal

All India financial institutions suffer from the following weaknesses:

1) **Procedural delays** : Due to complicated procedures involved from the stage of application till the final stage of disbursement of loans, inordinate delays are taking place. Cost of the projects are tilting away by the time the loan received. As a result, the beneficiary units are drastically affected.

2) **Urban** and **elite culture** : Since ail the offices (head offices, regional offices and branch offices) of all development banks are located at metropolitan cities and state capitals, their staff have no access to rural and backward areas. They had no opportunity to understand the problems of those areas. On the other hand, they develop some sort of urban and elite culture, which defeats the very purpose for which they are started in a country like India.

3) **Bias towards developed states** : Almost all development banks extended assistance to forward states like Maharashtra, Gujarat, Tamil Nadu and West Bengal instead of assisting backward states like Assarn, Orissa, Meghalaya, Arunachal Pradesh, Tripura, Mizoram, Sikkim and Nagaland. This is perhaps due to absence of infrastructural facilities. But it is to be noted that as long as financial assistance is not provided for industrial units, there is very little scope to develop infrastructural facilities.

4) **Overdues** : Overdues of development banks are increasing day by day and they have reached an alarming stage. Of the amounts given as loans, nearly one-third are standing as overdues inspite of several legal measures.

5) **Paucity of funds** : Yet another problem of development banks is paucity of funds. Obligations are many but resources are limited. Further, Governments are unable to extend their helping hand due to obvious reasons. As a result of growing inflation and increasing industrial activity, their limited resources could not meet the growing demands.

6) **Coordination** : In spite of IDBI's efforts, they lack coordination in the course of their activities with each other. As a result, duplication of work, contradictions in procedures, etc., are taking place.

Check Your Progress C

I) State whether the following statements are True or False.

i) IDBI is the apex institution of term finance in India.
ii) The paid-up capital of IDBI on March 1989 stood as Rs. 1,000 crore.
iii) The Board of Directors of IDBI deals with proposals for sanction of financial assistance.
iv) IDBI is also entrusted with the responsibility of planning, promoting and developing industries with a view to filling gaps in the industrial structure.
v) IDBI is also entrusted with the responsibility of planning, promoting and developing industries with a view to filling gaps in the industrial structure.
vi) IDBI has sponsored eight Technical Consultancy Organisations.
vii) IDBI is the principal agency for promoting small scale industry.
viii) Disbursement as a percentage of loan sanctioned has declined lately in case of IDBI.
ix) IDBI's activities have hampered the growth of new entrepreneurial talent.
x) IDBI also undertakes surveys in the field of investment.

11.110 LET US SUM UP

Development banks are a special kind of institutions which are a combination of a finance corporation and a development corporation. These development banks are established to supply three basic ingredients to industry : I) capital, 2) knowledge and 3) entrepreneurship.

Though origin of development banking may be traced to the early 19th century, it came up in its modern form after the World War II. The first development bank established in India was the Industrial Finance Corporation of India. It was established in 1948, followed by State Finance Corporations. Subsequently ICICI, IDBI, SIDC and SIDBI have been established.

The primary objective of IFCI is to provide medium and long-term credit to industrial units. In addition, it guarantees the loans, underwrites the issue of shares, debentures

and bonds and subscribes directly to the shares issued by industry. During its 42 years of existence the IFCI has sanctioned about Rs. 6,600 crore out of which Rs. 1,005 crore have been sanctioned only during 1988-89. Though the performance of IFCI has been good, yet it is criticised for providing resources to big concerns, and primarily to backward areas within advance states.

The ICICI was established in 1955 as privately owned and operated corporation. Its two main aims, besides the normal aims of a development bank, are to encourage foreign capital participated in the private sector and to encourage private investment in industry. It provides the facilities of loans, underwriting, guaranteeing and equity' participation. The non-traditional industries were the major beneficiaries of ICICI. This Corporation has significantly contributed to the growth of private industrial financial assistance to a few industries and geographical regions.

The IDBI was established in 1964 as a wholly owned subsidiary of the RBI. But it was made autonomous in 1976 and was asked to play the role of an apex financial institution. It provides term finance, technical and administrative assistance, and co-ordinate working of those institutions that are engaged in financing and promoting industries. It also acts as a refinancing agency for scheduled banks and other financial institutions. In terms of financial assistance sanctioned and disbursed, the performance of IDBI has been quite impressive. However, developed states like Maharashtra, Gujarat, Tamil Nadu, etc., received the major share of financial assistance. About 75% of assistance went to private sector. However IDBI has contributed significantly by helping weaker industrial units, developing small scale units and channelising funds for the development of backward areas.

IRBI was established to help in the revival of sick industries in India. Though it played a significant role in reviving sick units, it has been criticised for giving assistance to only a set of selected industries, slow working and the wide gap between sanctions and disbursements. The SIDBI was established in 1990 to promote, finance and develop small scale industries.

11.11 KEY WORDS

Authorised Capital : The amount of share capital in the memorandum of association and the articles of association of a company as required by the Companies Act.

Development Bank : A financial agency engaged in providing medium and long-term financial assistance to industrial undertakings in the form of loans.

Paid-up Capital : That part of the issued capital of a company that has been paid-up by the shareholders.

11.12 ANSWERS TO CHECK YOUR PROGRESS

A 1) i) True ii) False iii) True iv) True v) False
2) i) earliest ii) deferred; abroad iii) capital, knowledge, entrepreneurship.

B 1) i) medium; long ii) Central; World Bank iii) 200
2) i) True ii) False iii) False iv) True v) True

C 1) i) True ii) False iii) False iv) True v) True vi) True vii) False viii) True ix) False x) True

11.13 TERMINAL QUESTIONS

1) What do we mean by term lending? Discuss the role of special institutions that have been established recently in India with a view to solve the problem of term finance.
2) Critically examine the role of Industrial Development Bank of India as an apex institution.
3) Review the objectives and achievements of the Industrial Credit and Investment Corporation of India.

4) Has Industrial Finance Corporation of India become irrelevant recently given the emergence of a number of specialised financial institutions in India? Discuss.

Note : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.

UNIT 12 TERM-LENDING FINANCIAL INSTITUTIONS – STATE LEVEL

Structure

12.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the need for the state-level development banks
- describe the objectives, resources and functions cf term-lending institutions at the state level
- critically evaluate the performance of term-lending institutions at the state level.

12.1 INTRODUCTION

In the previous unit you have been introduced to various all-India term-lending financial institutions. You have studied their objectives, management, functions and working. In this unit you will study about various issues relating to the development banks at the State level in India.

12.2 NEED FOR STATE LEVEL TERM-LENDING INSTITUTIONS

Industrial Finance Corporation of India (IFCI) was established in 1948 at all India level to provide finance exclusively to large scale industrial units. Financial needs of medium and small size industries were not covered by IFCI. The government, therefore, felt the need for starting development hanks at the regional level to provide assistance to small scale industries. Consequently, State Financial Corporations (SFCs) and State lndustrial Development Corporations (SIDCs) were established in all the states. State level development banks were established with the following objectives:

1) To provide financial assistance to industrial units particularly small scale units in the State.
2) For establishing and managing the industrial estates.
3) To concentrate on the development of less developed parts of the States, through provision of infrastructure facilities like roads, electricity, drainage and water supply.
4) To establish institutes to provide training to the middle and high level technicians.
5) To decentralise the development banking activities and take them to semi-urban areas in the State.
6) To provide better access to the borrowers and clientle.
7) To have thorough knowledge about the local conditions and problems.
8) To overcome the problem of language and communication.

Now let us study the functions, types of assistance provided and the working of the two important term-.lending institutions at State level namely State Financial

Corporations (SFCs) and State Industrial Development Corporations (SIDCs) along with Technical Consultancy Organisations (TCOs).

12.3 STATE FINANCIAL CORPORATIONS (SFCs)

State Financial Corporations Act, 1951 was brought into force to enable all State Governments (except Jammu and Kashmir) to set up State Financial Corporations as regional development banks. They are to meet the financial requirements of small and medium size industrial units in the respective States. The first State Financial Corporation was established in Punjab in 1953. Subsequently Andhra Pradesh and Bihar State Governments took the lead to set up SFCs in 1960 followed by Uttar Pradesh, Karnataka, Gujarat, Maharashtra and Orissa. At present, there are 18 SFCs operating in different States and Union Territories in the country.

Financial Resources

Capital structure of an SFC is determined by the concerned State Government with a minimum of Rs. 50 lakh and maximum of Rs. 5 crore. They are also authorised to raise funds by issue of share capital, and issue of bonds and debentures guaranteed by State Governments. They can also accept medium and long-term deposits from public. In addition, they can borrow from other financial institutions.

Management

Every SFC is managed by a 12 member Board of Directors. The State Government concerned appoints the-Chairman and the Managing Director, and nominates three directors. IFCI and IDBI nominate one director each. Three directors are elected by financial institutions. The rest will be chosen on the basis of one each from schedule banks, cooperative banks and other financial institutions. One director is elected by non-institutional share holders.

Types of Assistance

SFCs provide the following types of assistance:

1) Granting of long-term loans to industries for the purchase of land, buildings and machinery.
2) Guaranteeing payment on behalf of the entrepreneur for purchasing machinery on deferred payments from suppliers within India.
3) Underwriting issue of shares, bonds and debentures of industrial concerns.
4) Guaranteeing loans raised by industrial concerns for a period not exceeding 20 years.
5) Guaranteeing loans raised by industries from commercial banks or co-operative banks for acquiring fixed assets.
6) Subscribing to debentures of industrial units.
7) Provision of foreign exchange loans to industries under the World Bank line of credit.
8) Special capital assistance upto Rs. 2 lakhs.
9) Loans to industries in collaboration with the central financial institutions like the IDBI, the IFCI and the ICICI, and joint financing of projects along with the SIDCs and the commercial banks.
10) Acting as an agent of the State or Central Government or any other financial institutions notified on this behalf by the Central Government.

Eligibility

Industrial concerns under any form of ownership viz., a proprietary concern, joint Hindu Family, registered co-operative society, private or public limited company engaged in or proposed to engage in one or more of the following activities are eligible for financial assistance.

1) Manufacture of goods
2) Preservation of goods
3) Processing of goods
4) Mining
5) 'Hotel industry
6) Development of industrial estates
7) Generation and distribution of electricity or any other form of power
8) Transport industry

9) Assembling, repairing or packing any article with the aid of machinery or power
10) Fishing or providing shore facilities for fishing or maintenance thereof
11) Providing special or technical knowledge or other services for the promotion of industrial growth.

Performance of SFCs

Operations of SFCs were on moderate scale during the fifties and sixties. But there was a rapid increase in their activities during seventies. It was due to the emphasis laid by Government on promotion of small scale industries, new entrepreneurs and development of backward areas. By March 1989, their cumulative sanctions and disbursements stood at Rs. 8,651 crore and Rs. 6,356 crore respectively. In 1988-89 alone, sanctions and disbursements accounted for Rs. 1,405 crore and Ks. 1,053 crore respectively. The details of financial assistance given by State Financial Corporations can be seen from Table 12.1

Table 12.1
Assistance Sanctioned and Disbursed by the State Finance Corporations from 1965-66 to 1988-89

Year	Sanctions		Disbursements	
	Amount. (Rs, crores)	Growth Rate(%)	Amount (Rs. crores)	Growth Rate (%)
1965-66	25.3		18.0	—
1970-71	49.6	—	33.5	—
1971-72	64.1	29.2	39.6	18.2
1972-73	78.7	22.8	44.7	12.9
1973-74	103.1	31.0	54.6	22.1
1974-75	141.8	37.5	79.6	45.8
1975-76	155.5	9.7	98.8	24.1
1976-77	163.3	5.0	105.2	6.5
1977-78	166.2	1.7	107.4	2.1
1978-79	200.7	20.8	135.0	25.7
1979-80	263.8	31.4	184.8	36.9
1980-81	370.5	40.4	248.0	34.2
1981-82	509.6.	37.5	317.7	28.1
1982-83	611.6	20.0	404.0	27.2
1983-84	644.9	5.4	435.5	7.8
1984-85	743.1	15.2	497.7	14.3
1985-86	1,009.1	35.8	608.5	22.3
1986-87	1,210.8	20.0	791.9	30.1
1987-88	1,284.7	6.1	938.0	18.4
1988-89	1,404.7	9.3	1,053.1	12.3
Cumulative upto March,,1989	8,651.5	—	6,356.2	—

Source: IDBI Report on Development Banking in India 1988-89, P. 49.

SFCs are playing an important role in financing small and medium scale concerns in their respective States. **They, however, are being criticised on the following grounds:**

1) **Recovery of Dues** : Recovery of dues is not satisfactory. For example, their arrears had trebled from Rs. 215 crore in 1979-80 to Rs. 623 crore in 1984-85. In case of many SFCs, overdues exceed their disbursements. Another disturbing trend is that the percentage of overdues to outstanding loans was increasing as is seen from Table 12.2. The mounting arrears are severely affecting resource position of SFCs.

2) **Assistance to Tiny Industries:** Financial assistance of SFCs to small industries sector is declining. This is evident from Table 12.3. Share of units which received assistance upto Rs, 50,000 is declining both in terms of number and amount. Contrary to this, share of units which were sanctioned assistance above Rs. 10 lakhs is continuously increasing in terms of number as well as amount. Further 6.2% of the units sanctioned loans above Rs. 10 lakh accounted for about 50% of total assistance of SFCs during 1984-85. As against this, small units which

accounted'for 42% of the total units received only 3.5% of the total sanctions given by SFCs.

Table 12.2 : Percentage of **Overdues** to **Outstanding** Loans

Year	Percentage
1980-81	25
1981-82	26
1982-83	26
1983-84	27
1984-85	29

Source: Economic Times, September, 15, 1986.

Table 12.3 : Size-wise Classification of Assistance

(Rs. in crores)

Year	Assistance upto Rs. 50,000		Assistance above Rs. 10 lakh	
	Number of Units	Amount	Number of Units	Amount
1980-81	19,603 (67.8)	28.82 (7.8)	787 (2.7)	142.95 (38.6)
1981-82	19,158 (59.8)	28.42 (5.6)	1,158 (3.6)	291.07 (43.4)
1982-83	17,382 (51.0)	27.99 (4.6)	1,366 (4.1)	256.63 (42.0)
1983-84	14,930 (48.1)	28.46 (4.4)	1,528 (4.9)	295.70 (16.0)
1984-85	13,087 (41.5)	26.89 (3.5)	1,955 (6.2)	385.13 (49.4)

Note: Figures in brackets indicate percentage to total.
Source: Economic Times, September 15, 1986.

3) Inadequate Resources : Many SFCs do not have sufficient funds to meet growing demands for their financial existence. In the recent past, the State Governments are found to concentrate more on welfare programmes. Hence, the SFCs are finding it difficult to arrange funds to meet their needs.
4) Increasing Sickness : Many of the assisted units are becoming sick resulting in an increase in the burden of debts.
5) Too many Formalities : The SFCs ,follow the same old process of scrutiny and processing of loan applications. Consequently, by the time a loan is finally sanctioned and disbursed, business scene may have undergone so much change, that the project is no longer an attractive proposition.

Check Your Progress A

1) State level term-lending institutions were needed to provide :

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2) State whether the following statements are True or False.
   i) All the Board of Directors of SFCs are nominated by the concerned State Government.
   ii) SFCs grant loans to large scale industries.
   iii) SFCs have not been able to recover their dues efficiently,
   iv) Almost all SFCs have surplus funds.
   v) SFCs provide the facility of guaranteeing the payments on behalf of the industrial units.

12.4 STATE INDUSTRIAL DEVELOPMENT CORPORATIONS (SIDCs)

Since 1960, many States and Union Territories started State Industrial Development Corporations (SIDCs) for accelerating industrial development in their respective States. In certain States these are called State Industrial Investment Corporations. Andhra Pradesh and Bihar were the first to set up Such corporations in 1960 followed by Uttar Pradesh and Kerala in 1961 and Maharashtra, Gujarat and Orissa in 1962. By the year 1988 there were 26 SIDCs spread all over the country.

Financial Resources

Besides paid-up capital and loans from State Governments, SIDCs also borrow funds from market by way of bonds and debentures and refinance from IDBI. Of the total resources aggregating Rs. 1,113 crore mobilised by SIDCs during 1988-89, break-up of contributions from different sources was as follows:

1)	Increase in paid-up capital	10.1%
2)	Borrowings by way of bonds	2.8%
3)	Repayments by borrowers	14.8%
4)	Institutional borrowings	33.5%
5)	Others	38.8%

Management

The SIDCs function under the guidance of respective State governments. Except for one nominee of the IDBI, all other members of their Boards of Directors are nominated by State governments. The boards constitute special committees as and when they feel necessary. Those committees advise the board on various issues relating to the business. Managing Director is the Chief Executive of an SIDC. He looks after its day-to-bay management.

Functions

The following are the functions of State Industrial Development Corporations:

1) Promoting industrial activities such as project identification, preparation of feasibility reports, identifying entrepreneurs and assisting them in project implementation.
2) Setting up of medium and large scale industrial projects either in joint sector or as wholly-owned subsidiaries.
3) Provision of infrastructural facilities and market intelligence services.
4) Granting of financial assistance by way of term loans/bridge loans and underwriting or subscription of equity and preference shares.
5) Acting as agent of State and Central Governments in respect of granting subsidies, incentives, etc.

Performance of SIDCs

Sanctions and disbursements of SIDCs are given in Table 12.4. As is seen from the table, their cymulative sanctions and disbursements stood at Rs. 4,356-crore and Rs. 3,136 crore respectively by March 1989. During the year 1988-89 they accounted for Rs. 742 crore and Rs. 531 crore respectively. Rapid expansion of operations of SIDCs in recent years is brought out by the fact that their aggregate assistance during the four year period, i.e., 1985-89, was more than the total assistance given by the SIDCs from their inception till 1985.

SIDCs are contributing a lot to the structural transformation of industry. In fact three-fifths of their total sanctions were in respect of units in non-traditional industries like chemicals, basic metals and metal products, machinery, etc. Their assistance for accelerating industrial development in backward regions is increasing substantially. For instance, by March, 1989, industrial units in backward areas accounted for 62.9% of the cumulative sanctions of SIDCs. Look at Table 12.5 which provides the details regarding the assistance sanctioned by SIDCs to backward areas.

Seed Capital Assistance

SIDCs have been playing an important role in widening the entrepreneurial base by operating the seed capital scheme on behalf of Small Industries Development Bank of India.

Table 12.4: Assistance Sanctioned and Disbursed by SIDCs

Year	Sanctions		Disbursements	
	Amount (Rs. crores)	Growth Rate (%)	Amount (Rs. crores)	Growth Rate (%)
1971-72	23.6	—	14.4	—
1972-73	23.5	(-) 0.4	16.6	15.3
1973-74	27.9	18.7	20.6	24.1
1974-75	33.5	20.1	26.7	29.6
1975-76	37.5	11.9	26.4	(-) 1.1
1976-77	71.8	91.5	35.0	32.6
1977-78	87.9	22.4	44.8	28.0
1978-79	98.3	11.8	60.1	34.2
1979-80	157.7	60.4	85.3	41.9
1980-81	216.4	37.2	124.6	46.1
1981-82	299.6	38.4	191.1	53.4
1982-83	296.6	(-) 1.0	208.0	8.8
1983-84	364.6	22.9	236.5	13.7
1984-85	477.9	31.1	297.6	25.8
1985-86	527.0	10.3	364.0	22.3
1986-87	570.3	8.2	425.1	16.8
1987-88	619.4	8.6	449.1	5.6
1988-89	742.3	19.8	530.7	18.2
Cumulative upto March 1989	4356.4		3135.8	

Source: IDBI Report on Development Banking in India, 1988-89. P. 56.

Under the scheme, equity type of assistance is provided to deserving new generation entrepreneurs who possess necessary skill but lack adequate resources.

Table 12.5 : Assistance Sanctioned to Backward Areas by SIDCs

(Rs. crore)

Year	Backward Areas	Non-backward Areas	Total
1986-87	362.0	208.3	570.3
	(63.5)	(36.5)	(100.0)
1987-88	411.2	208.2	619.4
	(66.4)	(33.6)	(100.0)
1988-89	438.9	303.4	742.3
	(59.1)	(40.9)	(100.0)
Cumulative upto March, 1989	2,741.4	1,615.0	4,356.4
	(62.9)	(37.1)	(100.0)

Note : Figures in brackets indicate percentage to total
Source: IDBI Report on Development Banking in India, 1988-89.

But SIDCs also suffer from the following problems and drawbacks :

1) Many of them are facing the problem of funds. The present availability of funds is not sufficient for growing needs of industrial units.
2) Overheads are becoming a big problem for almost all SIDCs.
3) Political interference in activities of SIDCs has been increasing.

12.5 TECHNICAL CONSULTANCY ORGANISATIONS

In addition to the availability of finance, technical codsultancy services play a very important role in the industrial growth of the country. The large scale industries can afford to maintain and equip separate technical consultancy departments or else they can spend good amount of money and can take the assistance from well established consultancy organisations. But the small scale units cannot afford the cost of services

of private consultancy units operating purely on commercial considerations. It is in this contex: thst the technical consultancy organisations (TCOs) were set up in the early seventies. The IDBI, IFCI and ICICI, in collaboration with State-level financial/development institutions ad commercial hanks, established a network of TCOs. At present, there are 17 TCOs in the country, some of them covering more than one State.

TCOs have been set up to provide a package of total consultancy services covering all stages in the project cycle under a single roof. TCOs also provide consultancy services to State Governments, State-level development financing institutions and banks. The major thrust of operations of TCOs is in the area of preparation of project reports and feasibility studies. Having gained experience over the years, TCOs have diversified into the fields of identification of potential entrepreneurs and their training, project implementation, rehabilitation, management consultancy, detailed design engineering, and turn-key services, besides energy audit and conservation.

During the year 1988-89, TCOs completed a total of 3.550 assignments, as against 3,082 during the previous year. The assignments included :

- 2,983 feasibility studies/project reports/profiles
- 31 project appraisals
- 170 industrial potential/ market/area development and other surveys
- 9 functional industrial complexes/turn-key assignments
- 219 modernisation/rehabilitation/diagnostic studies
- 138 other assignments/special studies

TCOs also prepared techno-economic feasibility reports involving investment of Rs. 503 crore and employment potential for 31,438 persons. Besides, they conducted 178 entrepreneurship development programmes (EDPs) where 3,316 entrepreneurs were trained. TCOs also conducted 54 entrepreneurship awareness camps and 12 training programmes under the self-employment scheme for educated unemployed youth (SEEUY).

Check Your Progress B

1) What are the major activities of SIDCs?

.....

.....

.....

.....

2) Fill in the blanks :

i) .....and ..... were the first states to set up SIDCs.

ii) The SIDCs function under the guidance of respective ....

iii) Under the .... scheme, equity type of assistance is provided to deserving new generation entrepreneurs.

3) State whether the following statements are True or False.

i) SIDCs have been playing an important role in widening the entrepreneurial base.

ii) Except for one nominee of State government, all other members of the Board of Directors of SIDCs come from IDBI.

iii) SIDCs are contributing a lot to the structural transformation of industry.

iv) TCOs provide technical consultancy to only the State level development financing institutions.

12.6 LET US SUM UP

State level term-lending institutions were needed to provide infrastructural facilities, training facilities and financial assistance to small scale units, besides helping in the development of backward areas in the State:

State Finance Corporations were established in 18 States and Union Territories to finance small and medium size industrial units. Every SFC is managed by a Board of

Directors with 12 members at present. It grants loans to industries to purchase land, buildings and machinery. It also guarantees payment on behalf of the entrepreneur, besides directly providing foreign exchange loans and subscribing to debentures of industrial units. The SFCs are playing an important role in financing small and medium scale concerns in their respective states. However, recovery of dues is not satisfactory and financial assistance to small industries is declining. However, SFCs suffer from inadequacy of resources and unnecessary formalities.

State Industrial Development Corporations (SIDCs)/State Industrial Investment Corporations (SIICs) have been set up by different states in India to promote medium and large scale industrial projects by providing financial and infrastructural assistance. There has been rapid expansion in the activities of SIDCs/SIICs in recent years, particularly in non-traditional industries, development of backward areas and providing seed capital assistance. Like SFCs, SIDCs/SIICs are also facing the problem of shortage of funds and overheads.

At the State level Technical Consultancy Organisations (TCOs) were set up to help small scale units. At present there are 17 TCOs in India and have significant contribution in providing technical consultancy.

12.7 KEY WORDS

Term Lending : A bank advance for a specific period (normally 3 to 10 years) to be repaid with interest usually at regular intervals.

Seed Capital Assistance : Equity type of assistance is provided to deserving new generation entrepreneurs who possess necessary skill but lack adequate resources.

12.8 ANSWERS TO CHECK YOUR PROGRESS

A 1) Financial assistance to small scale units; helping the development of less developed areas; providing infrastructural & training Facilities.

2) i) False ii) False iii) True iv) False v) True

B 1) promoting industrial activities; providing infrastructural and financial assistance; setting up industrial projects; Acting subsidies etc. on behalf of state governments.

2) i) A.P. and Bihar ii) State government iii) seed capital

3) i) True ii) False iii) False

12.9 TERMINAL QUESTIONS

1) Describe the structure of term lending financial institutions at the Slate level in India.

2) Critically evaluate the role of SFCs in the industrial development of states in India.

3) Discuss briefly the management, functions and performance of SIFCs/SIICs.

Note : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.

UNIT 13 : AGRICULTURAL FINANCE IN INDIA

Structure

13.0 OBJECTIVES

After studying this unit, you should be able to :

- discuss the importance of agricultural finance in lndia
- identify the sources of agricultural finance in India
- explain the role of commercial banks in agricultural finance
- describe the working of regional rural banks
- examine the role of National Bank for Agriculture and Rural Development (NABARD) in extending refinancing facilities to agriculture and rural development in lndia
- point out the persistent problems of agricultural finance in India.

13.1 INTRODUCTION

In the previous units you have studied about various financial institutions which provide assistance mainly to industrial units. In this unit you will study those financial institutions which provide financial assistance particularly to agriculture and allied sectors.

13.2 IMPORTANCE OF AGRICULTURAL FINANCE

The importance of agriculture as an occupation of nearly 70% of the population needs no emphasis. It is a well known fact that the Indian peasant is poor, illiterate and heavily indebted. For the relief of agricultural indebtedness, the Government of India and the State Governments have tried to regulate money lending, restrict transfer of land from agricultural to non-agricultural classes, and extend direct financial assistance in the form of **Taccavi loans.** Unfortunately, notwithstanding these sincere efforts on the part of the government, the economic conditions of agricultural masses has steadily deteriorated and the indebtedness increased. Before the advent of institutional credit, the major source of credit to the farmers was the **village mahajan** (money lender). Besides following many unfair practices, the village mahajans charge abnormal rates of interest.

With the breaking up of the village economy, loans were not available on personal security but on security of land. The new laws like the Indian Contract Act and the Civil Procedure Code were also in favour of money lender, and enabled him not only to secure his exorbitant claims but also to attach the debtor's land, cattle and implements. Consequently, the farmer was ruined.

The Government of India realised the urgency of the situation and appointed various committees in recent years to suggest ways and means to provide banking facilities in rural areas to mop up surplus funds and also to help the farmers with needed finance. On their recommendations cooperative banks, commercial banks and regional rural banks were created. The establishment of National Bank for Agriculture and Rural Development (NABARD) has further contributed to this process.

Depending on the period for which finances are required, the financial needs of the farmer may be broadly classified into three categories as follows:

1) **Short-term** or **seasonal credit** : Short-term loan is required by the farmers for purchasing seeds and fertilizers, paying wages and meeting other casual expenses such as payment of rent, interest on debt, etc. Short-term loan is generally repayable out of the proceeds of the next harvest.
2) **Medium-term credit** : This is required by the farmers to purchase live stock, expensive implements and to carry out land improvements of average duration. The loan is repayable in instalments spread over two to five years.
3) **Long-term credit** : This gives farmers the means to purchase land and agricultural machinery or to effecl permanent improvement on land such as drainage and irrigation. The returns from investments on such items are very slow and hence the farmers can repay the loan only in small amounts over a substantially long period (upto 30 years).

13.3 COOPERATIVE CREDIT SOCIETIES AND BANKS

Cooperative movement seeks to protect the agriculturist against economic evils as well as moral degeneration, while at the same time emphasising the importance of mutual help.

The cooperative movement in India may be said to begin with the passing of Cooperative Credit Societies Act of 1904. The publication of Rural Credit Survey Report in December 1954 was a landmark in the history of cooperative movement in the country. The various recommendations made in the Report were accepted by the Government of India, and State Governments were directed to draft their proposals for development of the cooperative movement during the plan period. The Second Five Year Plan envisaged setting up of an integrated rural credit structure based on three fundamental principles : 1) state partnership at different levels 2) full coordination between credit and economic activities (especially marketing and processing), and 3) administration with adequate trained personnel responsive to the needs of the rural population.

The medium and short-term cooperative credit structure in India has a three-tier structure: i) at the village level there are Primary Agricultural Cooperative Credit Societies, 2) Central Cooperative Banks at the district level, and 3) State Cooperative Bank as an apex body at the state level. The State Cooperative Banks supply funds to affiliated district level cooperative banks which in turn lend money to Village level cooperative credit societies. The other wing of cooperative credit structure provides long-term loans and it has a two-tier system : 1) the Primary Land Development Banks at the taluk level and 2) Central Land Development Banks at the State level. Let us study about these types in more detail.

13.3.1 Primary Agricultural Cooperative Credit Societies

Primary Agricultural Credit Societies constitute the pivot of the cooperative movement in India. A society can be formed by ten or more persons by filing with the Registrar of Cooperative Societies a copy of by-laws and other prescribed particulars. The area of operations is usually a village or a group of villages with a reasonably large membership and adequate share capital. The headquarters of a bigger primary credit society is conveniently located for the people of villages in its jurisdiction.

Primary Agricultural Credit Society has to play a vital role in the socio-economic development of the rural areas of the country. They are serving as mini-banks to supply finance, besides serving as counters to supply agricultural inputs and consumer goods. These societies also provide the facility of warehousing to preserve and store the foodgrains of the farmers. PACs are to be provided with adequate assistance in the form of subscriptions and grants by the higher level institutions such as Central Cooperative Bank and State Cooperative Bank within the federal structure of cooperative financing system.

The number of primary societies in India has been increasing over the years. By the end of 1983-84 the number of primary societies was 89,925, of which 83,766 societies were active and remaining were dormant. The working capital of these societies was Rs. 484.7 crore in 1983-84 while the loans issued during the year amounted to Rs. 415.44 crore of which Rs. 289 crore were for short-term purposes and Rs. 126.4 crore for medium term purposes.

13.3.2 Central Cooperative Banks

The central banking organisations are generally located at the district headquarters of other important towns in the districts, A Central Cooperative Bank derives funds for its working capital from two sources : 1).owned capital (comprising capital and reserves), and 2) borrowed capital (comprising deposits and loans). The business of these central cooperative banks consists of financing primary credit societies.

The Central Bank of a predominantly agricultural country like India has a very special role to play. In India, the district central cooperative banks form the connecting link in the chain of cooperative credit structure. Progress of cooperative credit programme largely depends on the strength of these banks because all the fund available from Reserve Bank of India for financing seasonal agricultural operations and marketing of agricultural produce are advanced to them on the basis of their financial strength and stability. The flow of fresh loans and advances during 1983-84 from the central cooperative banks increased by Rs. 468.4 lakh and working capital of these banks registered an increase of Rs. 465 crore during the last 13 years.

13.3.3 State Cooperative Banks

At the top of the cooperative movement, there is State Cooperative Bank. The need for establishing these banks was emphasised by the Maclagan Committee, which recommended the creation of a provincial cooperative bank capable of attracting deposits from the urban classes and channel them to agricultural sector through district central banks.

The State cooperative banks finance, coordinate and control the working of central banks in each state. They serve as clearing-houses of the excesses and deficiencies of the working capital of these central banks. They serve, moreover, as a link between the general money market and the cooperative primary societies in the villages. Generally speaking, the apex bank does not deal directly with primary societies but through central bank except in areas where central banks are not developed.

Functions of the apex banks include giving financial accommodation to the central cooperative banks and through them to the primary societies. Besides the normal banking activities they have also, taken interest in other cooperative activities such as helping various cooperative organisations to come together, financing the supply and distribution of essential commodities, etc.

13.3.4 Land Development Banks

The ordinary cooperative societies and banks cannot grant long-term loans to their members because the principle of cooperative lending demands that loans should be advanced on personal credit of members. But it is not possible to grant long-term advances on personal security alone. The Land Development Banks, therefore, supply long-term credit to the cultivator who offers his land as a security. These banks also give long-term loans to their members for the partial repayment of their debts, for undertaking permanent improvements on their lands and for purchasing new plots of land. In Tamil Nadu and Maharashtra, the Central Land Development Banks issue debentures for obtaining finance. These debentures are usually guaranteed by the

State Government. The LDBs also accept long-term deposits from the public. These banks get financial assistance from the Life Insurance Corporation of India also.

Land development banking, as in the case of rural cooperative banking, has made some progress in the states of Maharashera, Gujarat and Tamil Nadu. Like the primary cooperative banks, the land development banks have also been charging rather a high rate of interest on the loans which they advance to the cultivators. Moreover, there is considerable amount of delay in the sanctioning of loans because of shortage of trained staff. Due to these shortcomings, the LDBs in India are able to provide only a negligible proportion of the long-term credit required by the cultivators.

Check Your Progress A

-1) The three tiers of the cooperative credit structure in India are:

.....

.....

.....

2) Land Development Banks give loans to its members for the purposes of :

.....

.....

.....

3) The central cooperative bank derives funds for its working capital from two sources :

i) ..... capital comprising capital and reserves; and

ii) Borrowed capital comprising ..... and .....

4) Fill in the blanks :

i) Prior to the advent of institutional credit, the main source of rural credit was the village .....

ii) Credit required for purchasing seeds and fertilisers is the ..... tcrrn credit.

iii) Long-term loans can be repaid upto .....years.

iv) At the apex of the cooperalive movement is the .....

13.4 COMMERCIAL BANKS

In spite of the fact that agriculture and allied activities were contributing about 40% to India's national income and supporting almost three out of every four employed persons in the country, the contribution of commercial banks to agricultural development till 1955 was not even one per cent of their aggregate resources. Things have changed after nationalisation of commercial banks in 1969.

'She real involvement of banks in agricultural financing coinnienced with the introduction of social control in 1967. The study group appointed under the Chairmanship of Professor D.R. Gadgil in October 1969, and the Committee of Bankers set up by the RBI in 1969 under the Chairmanship of F.K.F. Nariman recommerided an Area Approach for providing banking facilities in unbanked districts. As a result, the **Lead Bank Scheme** was introduced by the RBI in December 1969. Under the scheme, various districts in the country came to be apportioned ainong all the public sector banks and three banks in the private sector. The banks were charged with the responsibility of preparing development programmes for their respective districts. The scheme, by introducing commercial banks to rural areas, involved them in financing agriculture. Nationalisation of the 14 major banks in July 1969 accelerated the association of banks with agricultural finance.

Apart from the three major forces (viz., the social control, the Lead Bank Scheme and Bank Nationalisation) that are responsible for the association of commercial banks with agricultural financing, sharp rise in the number of bank branches in rural areas also contributed to the development of agriculture and related activities.

There are three distinct phases in involvement of commercial banks in financing agriculture. The first phase, spreading roughly between 1952 and 1967, was a period when bankers were thinking that financing agriculture was not their job and that this responsibility would be withdrawn soon. No wonder, the growth in agricultural financing was haphazard during these years.

The second phase, commencing from 1967 till 1975, was the period when the banks realised that agricultural financing has come to stay. During this period the banks engaged in experimenting with various schemes and setting the pace for promoting farm finance. During this period, commercial banks attained valuable experience in agricultural finance. They acquired the necessary knowledge of their clientele as also of the areas, which helped them to evolve a suitable approach towards financing agriculture.

The third phase, commencing with 1975, marks the awareness among banks that their own efforts would not suffice. They have realised the magnitude of the task and are convinced that the cooperation of other agencies is essential. They are also experimenting in agricultural financing with organisations like the Farmers Service Societies, the Regional Rural Banks, the Primary Agricultural Cooperative Societies, ktc.

13.4.1 Types of Agricultural Finance

The commercial banks provide loans for all agricultural operations and allied purposes. These may broadly be classified into 1) direct advances, and **2)** indirect advances.

Direet Agricultural Credit

It takes the form of short-term, medium term or long-term loans. Short-term loans may be in the form of i) crop loans, or ii) production loans. Crop loans are required to meet the cost of raising annual crops such as cereals (like rice, wheat, etc.,) oil seeds (such as groundnuts), and cash crops (such as: sugarcane, chillies, tobacco, cotton, etc.). Production loans cover the annual maintenance cost of perennial plantation crops such as tea, coffee, cardamom, etc.

Though short-term credit is mainly in the form of loans, yet in a few cases production credit is also granted in the form of cash credit limit. Short-term credit assistance granted by banks normally carries a stipulation for repayment within a month or two after the harvest of crops. In order to ensure recovery of funds lent and effective recycling of funds, the banks normally go in for a system of tie-up arrangements, wherever possible. For example, often tie-up arrangements are entered with sugar mills in the case of loans granted to sugarcane growers, with the Coffee Board for financial assistance granted to coffee plantations, etc.

Medium and long-term loans are generally granted to meet the investment costs relating to various agricultural development programmes which are capital intensive and which ensure flow of benefit over a period of time ranging normally from three years onwards, depending upon the type of project undertaken. The repayment schedule of term loans granted by banks ranges between 3 to 15 years, depending upon the nature and size of the project and the likely cash flow therefrom. Almost all types of investments in such agricultural projects which are otherwise economically viable and technically feasible come within the ambit of banks credit portfolio.

Term lending is assuming greater importance in view of the need to bring additional area under the plough in the country and the consequent need to revitalise the existing cultivable area and thereby increase its productivity. However, the long-term credit requirements of agriculture are massive and hence cannot be fully met by commercial banks alone. However, in providing refinance assistance to banks in respect of most of the term loans granted by them, NABARD has provided the necessary fillip to commercial banks to take to agricultural financing in a massive way.

Indirect Advances

The indirect advances include the following four types:

1) Advances which fulfil the criteria laid down for direct agricultural credit, but routed through other agencies (such as farmers' service societies, primary agricultural credit societies, etc.) which in turn finance their members.

2) Advances made to State Electricity Boards for electrification and thereby helping energisation of pumpsets for agricultural purposes.
3) Credit granted to dealers in fertilisers to meet their working capital requirements.
4) Advances made to cooperative milk societies, sheep rearing cooperative societies, etc., which in turn extend credit assistance to their members for. purchase of cattle, etc.

13.4.2 Limitations of Commercial Banks as a Source of Rural Credit

During the last two decades the commercial banks have gone around their task of providing banking services in rural areas quite earnestly. However, in the process the commercial banks faced a number of problems, some of which are discussed below:

1) The commercial banks have probably not been sufficiently frank to bring to public notice the cost of conducting agricultural advances as they are incurring huge loss in opening and operating rural branches. They have also problems in training their staff to go to rural centres for making agricultural advances. Over the last twenty years a number of their officers have been found guilty of malpractices and/or gross negligence.
2) Of the 5.75 lakh villages in the country, the commercial banks have spread their activities to 46,000 villages only.
3) The commercial banks are quite selective in their village adoption approach. The villages which are relatively more backward and deserve immediate development assistance have not been adopted by them. Besides, farmers-engaged in dry land agriculture constituting about 75% of the Indian agricultural population have not got their due attention.
4) Although small and merginal farmers have been included by commercial banks on their 'target population' list, the rates of interest charged on advances are very high. In a number of commercial banks the old system and procedures of granting advances continue to exist. The farmers have to, therefore, spend a lot of avoidable money and waste time in satisfying legal formalities.

Thus, there is still a large gap persisting between the demand and supply of rural credit in India. This calls for a long range, careful and realistic planning taking into. account the existing operational deficiencies and problems.

Check Your Progress B

1) What is lead bank scheme ?

.....

.....

.....

2) State whether the following statements are **True** or **False.**
   i) The contribution of commercial banks in financing agriculture was very high till 1969.
   ii) The Lead Banks are charged with the responsibility of preparing development programmes for their respective districts.
   iii) Commercial banks also route funds for agricultural credit through Farmers' Service Societies.
   iv) Rates of interest charged by commercial banks on advances is very low.
3) Fill in the blanks :
   i) Production loans are required to meet the maintenance cost of .... crops.
   ii) ..... advances include credit to dealers in fertilisers to meet their working capital needs.
   iii) Commercial banks have been to be quite ..... in their village adoption approach.

13.5 REGIONAL RURAL BANKS

The Banking Commission in its report submitted to the Government m 1972 recommended the formation of rural banks. These rural banks were described as primary banking institutions for serving a compact group of villages, covering a

population of 5,000 to 20,000. In the context of the urgency for the liquidation of rural indebtedness, the Government was keen on establishing rural banks as quickly as possible. The Regional Rural Banks Ordinance was, therefore, enacted on September 26, 1975, and it came into force with immediate effect in the whole of India.

The main objective of the Ordinance is to provide for the establishment of Regional Rural Ranks for provision of credit and other facilities specially to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs in rural areas. The Central Government on the request of any bank (usually the Lead Bank of that area), called the 'sponsor bank' can establish in a State or Union Territory one or more rural banks. Each rural bank will operate within the local limits. If it is necessary, a rural bank might also establish branches or agencies at any place notified by the Government.

A sponsor bank will assist the rural bank in several ways. It will subscribe to the share capital of the rural bank, assist in its establishment, recruitment and training of its personnel during the initial period of functioning of the rural bank. According to the Ordinance, the authorised capital of each rural bank will be Rs. 1 crore. The issued capital of each rural bank will be Rs. 25 lakh. Of the issued capital, 50% will be subscribed by the Central Government, 15% by the concerned State Government and 35% by the sponsored bank. There is a provision for increasing both the authorised and issued capital after consultation with the Reserve Bank and sponsored bank and with the prior approval of the Central Government.

The general supervision, direction and management of the rural banks is vested in a Board of Directors. In discharging its function, the Board should act on business principles and should have due regard to public interest. Besides the Chairman, the Board of Directors of a rural bank will consist of not more than three Directors to be nominated by the Central Government, not more than two Directors to be nominated by the concerned State Government and not more than three Directors to be nominated by the sponsor bank. The lending rates of rural banks will not be higher. than the prevailing lending rates of cooperative societies in that particular State. The rural banks are permitted to give half a per cent higher interest on the deposits kept with them. The staff of rural banks will be composed of men who have knowledge of local conditions and are responsive to the rural needs.

On October 2, 1975 the first five regional rural banks were set up in West Bengal, U.P., Rajasthan, and Haryana. By the end of 1985 there were 187 regional rural banks with 12,000 branches covering 337 districts. The tbtal deposits mobilised by these banks aggregated to over Rs. 1,159 crore and total advances amounted to Rs. 1,333 crore.

It needs to be mentioned here that the Dantwala Committee set up by Reserve Bank of India in June 1977 to review the performance of regional rural banks came out strongly in favour of their continuance and extension. The Committee came to the conclusion that the establishment of regional rural banks should be encouraged as these are well suited for progressively filling up the credit gap in rural areas. It was of the view that commercial banks be persuaded to progressively entrust their rural credit business, currently handled by their rural branches, to the regional rural banks keeping in view the RRBs capability to shoulder the responsibility. The Dantwala Committee was not in favour of total replacement of the rural branches of the commercial banks by the RRBs. It, however, suggested'that steps be taken to initiate the process of making regional rural banks an integrated part of the rural credit structure.

Following the establishment of National Bank for Agriculture and Rural Development (NABARD), refinance facilities to RRBs (hitherto available from RBI) are now available from NABARD. During 1984-85 the NABARD's refinance policy for RRBs underwent a change. The composite limit, hitherto sanctioned to RRBs was bifurcated into short-term limit and medium-term (non-schematic) limit. Under the new policy, RRBs which have completed 5 years of existence as on July 1, 1984 are required to apply for separate limits under short-term and medium-term. Other regional rural banks are, however, eligible for a composite limit as hitherto. During 1984-85 the NABARD has sanctioned medium-term (non-schematic) loans

aggregating Rs. 202.5 crore to 126 regional rural banks. The outstanding amounts against medium-term (non-schematic) limits were Rs. 124.7 crore and Rs. 182.7 crore in respect of short-term limits as on June 30, 1985.

The regional rural banks, which have been set up in rural India are desgined to play a pivotal role in rural credit. They have been evolved as low cost and rural based institutions. Their operational area will be relatively small and their staff is to be recruited locally so that they will be familiar with the local conditions and local languages. The regional rural banks, by bringing credit facilities very nearer to the door of the poorer sections of the rural people, will help to relieve them from the grip of the money-lender. Incidentally, it should be mentioned here that small/ marginal farmers, agricultural labourers, artisans and other weaker sections in rural areas constitute the main beneficiaries of loan assistance from regional rural banks.

It should be noted here that the lead bank scheme and the proposal for the setting up of regional rural banks are complementary to each other. So far, the lead bank has been the sponsoring bank for the regional rural banks and as such, the establishment of the rural bank should be viewed as a suitable institution for strengthening the institutional structure in the district where the lead bank is expected to play a dominant role in financing.

As the rural banks are now taking up the implementation of all bankable schemes which concern the small and marginal farmers, rural artisans and landless labourers, it is desirable that these rural banks have their representatives in the district consultative committees in all the districts where these banks are operating. This will bring about greater involvement of the rural banks in the lead bank scheme. Moreover, the opening of regional rural banks in the districts will help to remove the two big constraints which the banking system has hitherto been experiencing in implementing the lead bank scheme : 1) inadequate number of banking offices in remote parts of the country, and 2) high cost of servicing small'accounts.

Studies undertaken by RBI in 1980 have brought out that it was not possible for some branches of RRBs to become economically viable owing to competition from commercial and cooperative banks and also because of their location at centres endowed with limited potentiality. Nevertheless, it is heartening to note that the RRBs had been able to fulfil the prime objective of meeting the credit requirements of rural poor.

13.6 NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT (NABARD)

The NABARD came into existence on June 12, 1982 following the recommendations of the Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development (CRAFICARD). The Committee set up by the RBI in March 1979 submitted its final report in March 1981. The setting up of NABARD as an apex body for rural credit could be construed as a logical step in the organisational. evolution of Reserve Bank to decentralise its functions retaining the essential controls. , Although NABARD has been entrusted with the task of overseeing the entire rural credit system, the organic link of RBI with NABARD has been retained by formally contributing half of its share capital and by nominating three of its Directors on the Board of NABARD with a Deputy Governor of RBI as Chairman. NABARD has taken over entire functions of the Agriculture Refinance and Development Corporation (ARDC) as well as the refinancing role of RBI vis-a-vis State Cooperative Banks and Regional Rpral Banks.

The capital of the Bank is Rs. 100 crore subscribed by the Central Government and the RBI in equal proportions. For its term loans, the NABARD draws funds from the Government of India, World Bank and other multilateral and bilateral agencies as well as the domestic money market..

13.6.1 Functions

Financial Functions

One of the most important functions of NABARD is to extend production and marketing credit which include, inter alia, refinance loans and advances repayable over periods not exceeding 18 months to State Cooperative Ranks, Regional Rural Banks and other financial institutions. This facility of loans and advances is available for agricultural operations and marketing of crops, marketing and distribution of agricultural inputs, marketing activities of artisans or small scale industries, etc: The NABARD is also empowered to extend loans and advances against. the security of stocks and promissory notes. Incidentally, the short-term loans granted to state cooperative banks (SCBs), Regional Rural Banks (RRBs) and financial institutions as approved by the RBI can be converted into medium-term loans for a period not exceeding 7 years under conditions of famine and other natural calamities. Medium-term loans for periods not less than 18 months but not exceeding 7 years are granted to SCBs and RRBs for agriculture and rural development and some other purposes as the NABARD determines from time to time. The NABARD has been permitted by the Act to contribute to the share capital of or purchase and sale shares of, or invest in the securities of any institution engaged in agriculture and rural development.

In an effort to promote agriculture and rural development, the NABARD also grants long-term loans and advances to Land Development Banks (LDBs), RRBs, commercial banks, SCBs and other financial institutions. Furthermore, NABARD is entitled to extend loans and advances to the State Governments from the National Rural Credit (long-term operations) Fund for periods not exceeding 20 years to enable them to subscribe directly or indirectly to the share capital of a cooperative credit society.

Coordinating, Advisory and Miscellaneous Functions

Apart from being a source of different types of loans and advances, NABARD is also entrusted with the task of coordinating the operations of several institutions engaged in the field of rural credit and also to maintain expert staff for studying the'problems besetting agriculture and rural development.

NABARD maintains a Research and Development Fund (RDF) to help and promote research in agriculture and rural development including the provision of research and training facilities. The Central Board of NABARD is also empowered to establish a 'Reserve Fund' or any other fund as it deems fit. NABARD undertakes the inspection of RRBs, besides the cooperative banks. Applications from these banks seeking permission for opening new branches are, however, submitted to the NABARD for onward transmission with comments to the RBI. Furthermore, the RRBs and the cooperative banks have to furnish to NABARD the copies of the returns which the former submit to the RBI under various sections of the Banking Regulations Act.

13.6.2 Performance

Since Its inception in 1982, the NABARD has initiated a number of measures for augmenting the flow of credit to the rural sector in general and to small and marginal farmers in particular through strengthening the institutional rural credit structure. Recently, the NABARD has also decided to liberalise the terms of lending in order to stimulate credit flow to the rural non-farm sector. The quantum of refinance assistance to the commercial banks, cooperative banks and RRBs has been stepped up from 90% to 100% of bank loans.

NABARD has helped in achieving the growth targets in farm and non-farm sectors. Its operations and objectives have been dovetailed into other national objectives like balanced regional growth, economic improvement of the weaker sections of the rural society, etc.

Aggregate short-term credit limit sanctioned for financing seasonal agricultural operations to State Cooperative Banks amounted to Rs. 1,233 crore during 1984-85 as against Rs. 1,245 crore during 1983-84. The performance of NABARD in respect of medium and long-term credit was equally impressive. NABARD's medium-term loans for approved agricultural purposes increased sharply from Rs. 32 crore at the end of June 1984 to Rs. 158 crore at the end of June 1985. IRDP was the second important

programme to which NABARD committed Rs. 302 crore and disbursed Rs. 291 crore during 1985-86.

NABARD has laid greater emphasis on agricultural credit. As a result,.its assistance to agriculture and allied activities has gone up tremendously. NABARD has also provided substantial refinance for IRDP and for bringing about necessary improvements in lending for poverty alleviation programmes.

A close analysis of the flow of rural credit reveals that NABARD has met with little success in reducing imbalances in rural development, as North Eastern region accounted for about 2.1% of its refinance in 1985-86 as against 2/3 of cumulative disbursements in Northern, Southern and Western regions.

Check Your Progress C

1) State whether the following statements are **True** or False.
   i) The Regional Rural Banks Ordinance was enacted in 1975.
   ii) A sponsored bank competes with the RRB.
   iii) NABARD extends refinance facilities to RRBs.
   iv) RRBs are taking up all such schemes which help the marginal farmers, rural artisans and landless labourers.
   v) NABARD was set up in 1972.
   vi) Subscribed capital of NABARD is Rs. 100 crores.
   vii) NABARD grants long-term loans to LDBs and RRBs.
   viii) RRBs undertake the inspection of NABARD.
   ix) NABARD is making efforts to strengthen the base of rural credit.
   x) NABARD has succeeded in eliminating regional imbalance.

13.7 LET US SUM UP

The magnitude of rural indebtedness has been continuously increasing indicating the poor economic situation of peasants. Farmers require two types of loans: i) Consumption loans, and ii) Production loans. On the basis of time, loans can be classified into three categories as short-term, medium-term and long-term loans.

Farmers can borrow from non-institutional agencies as well as institutional agencies. With the establishment of cooperative banks, the share of institutional credit in the total has gone up over time. Since 1970 India has relied on multiagency approach to rural credit in which institutions like cooperatives, commercial banks and regional rural banks have participated.

Cooperative institutions, with three-tier structure of Primary Agricultural Cooperative Credit Societies, Central Cooperative Banks and State Cooperative Banks, provide short-term and medium-term loans while Land Development Banks provide long-term loans. However, these could not provide adequate finance to agriculture sector. Since 1969, commercial banks have started participating in rural credit by providing crop loans and term loans.

Regional Rural Banks have been set up to help the weaker sections in the rural areas. The public sector banks have been empowered to sponsor RRBs by participating in their capital and also organising and staffing them in the initial stages. Though RRBs have largely succeeded in helping the poor and weaker sections of the society, they have been caught up by problems like inadequate resources and mounting overdues.

NABARD has come into existence in June 1982 mainly to extend refinance facilities to agricultural cooperatives, rural banks and commercial banks for short, medium and long-term requirements. The real purpose of the NABARD will be measured by the transformation it can bring abaut in the rural credit system so as to shape it into an effective instrument for the welfare of poor peasants.

13.8 KEY WORDS

Credit Structure : Various levels at which the credit is made available.

Social Control : When the production is asked to serve social priorities, along with the commercial objectives.

13.9 ANSWERS TO CHECK YOUR PROGRESS

A 1) Primary Agricultural Cooperative Credit Societies, Central Cooperative Banks, State Cooperative Banks.
2) Purchasing new plots of land, permanent improvement in existing land, reduction of debt.
3) i) owned ii) deposits; loans
4) i) Mahajan ii) short iii) 30 iv) State Cooperative Banks.

B 2) i) False ii) True iii) True iv) False
3) i) perennial plantation ii) indirect iii) Selective

C I) i) True ii) False iii) True iv) True v) False vi) True vii) True viii) False ix) True x) False

13.10 TERMINAL QUESTIONS

1) Explain the need for institutional finance for agriculture in India.
2) Discuss how cooperative banks are helpful to the farmers in solving the problem of indebtedness.
3) Explain the contribution of cooperatives to the financing of agriculture in India.
4) Explain clearly the main source of agricultural credit in India. How far the nationalised banks have been able to meet the credit needs of the farmers?
5) Assess the achievements of commercial banks in India.
6) How far NABARD has been successful in creating refinance facilities to the other banks in India?
7) Examine the salient features of Regional Rural Banks.
8) Discuss the recent changes in the supply situation of rural credit in India.

Note : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.

SOME USEFUL BOOKS

Gupta, S.B. 1982. *Monetary Economics,* S. Chand & Co, New Delhi. (Chapter 9)

Mishra, S.K., 1990. *Money, Income and Financial Institutions,* Pragathi Publications, Delhi. (Chapter 22)

Mithani, D.M., 1990. *Money Banking International Trade and Public Finance,* Himalaya Publishing House, Delhi. (Chapter 17)

Sundaram, K.P.M., 1989. *Money, Income and Financial Institutions,* Sultan Chand & Sons, New Delhi (Chapter 5)

ECO-09 MONEY, BANKING & FINANCIAL INSTITUTIONS
Course Components

BLOCK	UNIT NO.	PRINT MATERIAL
I		**Monetary Theory**
	1	Money, Nature, Functions and Significance
	2	Demand for and Supply of Money
	3	Money and Prices
	4	Inflation
2		**Banking Theory and Practice**
	5	Commercial Banking
	6	Commercial Banking in India
	7	Central Banking
	8	Reserve Bank of India
	9	Indian Money Market
3		**Non-Banking Financial Institutions in India**
	10	Non-Banking Financial Internaediation-AnOverview
	11	Term Lending Financial Institutions-All India Level
	12	Term Lending Financial Institutions-State Level
	13	Agricultural Finance in India
4		**International Financial System**
	14	International Financial System
	15	International Monetary Fund
	16	World Bank

UNIT 14 INTERNATIONAL FINANCIAL SYSTEM—AN INTRODUCTION

Structure

14.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain the need for international finance
- Describe the structure of international finance.
- Discuss the working of the foreign exchange market
- State the nature and working of international mdney and capital markets
- Describe the role of leading international financial institutions.

14.1 INTRODUCTION

International financial system refers to the system for the flow of funds between nations. The need for the flow of funds arises on account of two reasons. First, the trade between the nations often requires international transfer of funds. Since trade rarely assumes the form of barter, there is normally either a surplus or a deficit in the balance of trade of a country. This will require transfer of funds between the countries. A second category of transfer of funds from one country to another involves long-term capital flows. These may be at both the government and the private levels. In this unit you will study the need for international financial flows as well as the institutional arrangement that exists to facilitate such flow of funds. In particular, you will study the functioning of foreign exchange market, international money and capital markets, roles of the International Monetary Fund, and the, World Bank and its affiliates.

14.2 NEED FOR INTERNATIONAL FINANCE

The need for international finance is of two kinds: 1) short-term, and 2) long-term.

The balance of payments of almost all countries are invariably in disequilibrium. This implies that there is either a surplus or a deficit in the balance of payments. This would require flow of short-term funds from a surplus to a deficit country. On the other hand, flow of long-term capital between the countries is guided by two factors: 1) the foreign capital needs of developing countries and 2) the investment opportunities available abroad, Now let us discuss in detail about short-term requirements and long-term requirements separately.

14.2.1 Short Term Flow of Funds

As discussed earlier, the need for short term flow of funds at their international level arises from the disequilibrium in the balance of payments of the various countries. But what does this disequilibrium mean? The balance of payments of a country refers to the net claims of a country against the rest of the world arising from the transactions over a certain period. **When these claims are positive, the balance of payments is said to be favourable, while if these claims are negative the balance of payments is termed as unfavourable.** In order to follow this statement, it is necessary to understand the hook-keeping of the balance of payments. In Table **14.1** given below, accounts of a country's balance of payments have been presented in a summary form.

Table 14.1
Account of a Country's Balance of Payments (An Illustration)

Receipts (Credit)	Amount ($)	Payments (Debit)	Amount ($)
Exports of goods	1,300	Imports of goods	1,400
Exports of services	140	Imports of services	120
Unilateral receipts	160	Unilateral payments	40
Capital receipts	300	Capital payments	400
Exports of gold	100	Imports of gold	40
Total receipts	2,000	Total payments	2,000

The balance of payments of a country involves double entry book keeping and is, thus, always in balance. This implies that total receipts are equal to total payments. If you look at Table **14.1** carefully, you will observe that both credit and debit sides have the same total, that is $2,000. Still the balance of payments of this country may not be in equilibrium and may require flow of short-term funds between this country and the rest of the world. This is really a paradoxical situation and it deserves careful attention. Since this is a somewhat complex situation, it is necessary for us to consider each item of the balance of payments account separately.

1) **Commodity exports and imports** : In the balance of payments accounts of a country the most important item is commodity trade, i.e., exports and imports. While commodity exports from a country create claims on importing countries, commodity imports result in debt obligations to the countries which have exported goods to this country. Unless exports and imports are done by a country strictly on barter basis, they are not equal. Even in cases where foreign trade is planned and regulated by the government of a country, there may be either a deficit or a surplus in the balance of trade of a country. This would lead to flow of short-term funds between the country and its trading partners, provided payments and receipts under the other heads (as shown in Table **14.1)** do not eliminate the need for this flow.

2) **Invisibles, exports and imports** : Along with exports of goods a country also exports services in its various forms which create claims against the foreigners. All these claims appear in the balance of payments accounts of a country on the receipt side. In Table **14.1,** you will observe that the exports of services appear on the credit side of the balance of payments accounts. Now, the form in which a country exports services requires some explanation. Major services items generally included in the balance of payments accounts are payments for shipping and freight services, payments for banking, insurance and brokerage services, returns on foreign investments', expenditures by the foreign tourists and the residents of the country abroad, and expenditures incurred by government agencies abroad, and the foreign government agencies in the country. Let us

consider the case of some country, say India. Suppose, shipping, banking insurance and such other services are provided by the Indian companies to foreign firms, claims would be created against them and thus these services would appear in India's balance of payments on the receipts side. Conversely when the Indian firms avail the services of foreign shipping corporations, banks and insurance companies, they would have claims against the Indian concerns and these would appear in India's balance of payments on the payments side. The same is true of other receipts and payments items.

3) **Unilateral transfers** : Unilateral transfers, such as personal remittances, gifts, grants, and indemnities, etc., do not involve any claim for repayment, and are, therefore, termed as **unrequired transfers.** These transfers may appear on both credit and debit sides of the balance of payments accounts of a country. Let us first see what unilateral transfers would appear on the credit side of the balance of payments.

A country may receive grants and gifts from foreign governments and institutions involving no repayment obligation. In the balance of payments account, these would be shown as the receipts item on the credit side. Over the past three decades the less developed countries have received substantial grants from the developed countries. Remittances are a recent phenomenon. In India's case remittances have constituted the substantial portion of the unilateral transfers on the credit side of the balance of payments account. Indemnities and separations are not normal transfers. These were collected by the USA and its allies from Germany after World War I. These receipts appeared in the balance of payments accounts of the recipient countries of reparations. When these unilateral transfers appear on the debit side of the balance of payments account, then it means that the country has made gifts and grants, has paid reparations, and has permitted remittances.

4) **Capital receipts and payments** : Receipts and payments on account of exports and imports of commodities and services and unilateral transfers constitute the current account of the balance of payments. There is invariably a deficit or a surplus in this account. In the capital account of the balance of payments of a country, all autonomous transactions involving receipts and payments of money capital are registered'. Capital flows between countries take various forms such as borrowings, repayments of loans and foreign private and public investments. When a country receives loans or raises equity capital the amount raised is shown as capital receipts on the credit side. The repayment of loans and repatriation of foreign capital are shown on the debit side of the balance of payments accounts. Like the current account, the capital account of the balance of payments shows either a deficit or a surplus. However, it is only when we take both the current and capital accounts together that we know Whether there is a net deficit or a net surplus in the balance of payments accounts of the country.

5) **Gold movements** : Gold movements between the countries is of two kinds. First, it may be exported or imported like any other commodity. In such a case it is not to be distinguished from other commodities. In the second case gold movements are caused by the need to offset deficits in the balance of payments. When this is done, gold performs the function of the medium of exchange at the international level. In the balance of payments accounts of a country, import and export of gold are treated in the same manner as exports and imports of other goods, i.e., exports of gold are shown on the credit side while imports of gold appear on the debit side. Thus merely from balance of payments accounts one would fail to know the actual reasons for gold movements.

Having discussed the book keeping of the balance of payments, we are now in a position to follow the meaning of disequilibrium in the balance of payments. The difference between the exports and imports of a country is known as the balance of trade. **When exports exceed the imports, the balance of trade is said to be favourable.** Conversely **when imports exceed exports, the balance of trade is considered to be unfavourable.** The deficits in the balance of trade may be offset or accentuated depending upon whether the other heads have a surplus or a deficit. In Table 14.1 the country is shown to have a deficit of $60. If we consider the current

account constituting trade of commodities and services and the unilateral transfers, we find that there is a surplus of $40. Since capital receipts are $300 and capital payments are $400, there is a deficit of $100 in the capital account. Considering both the current and capital accounts, we note that there is a net deficit of $60. This has necessitated a net export of gold amounting to $60. This deficit could also be offset by taking short-term loans from capital-surplus developed countries and international financial institutions like the International Monetary Fund.

14.2.2 Long Term Capital Flows

While explaining the book-keeping of the balance of payments a reference has been made to capital flows. You will now learn that the long-term capital flows are caused by the development needs of the various countries. Presently the world can be broadly divided into the capital surplus countries and the capital deficit countries. Most developed countries are the capital surplus countries, while almost all developing countries are the capital deficit countries. Since the countries falling in the latter category have not been able to save adequately for their investment requirements they import foreign capital from the capital surplus countries.

Foreign capital usually takes two main forms : i) private foreign investment, and ii) foreign aid. Before World War 11, private foreign investment was used by the colonial powers to exploit the market of the colonies. Since these colonies have become independent, the penetration of private foreign investment in its earlier form has stopped. Currently private foreign investment assumes two forms : i) direct foreign investment, and ii) indirect foreign investment. **The bulk of the direct foreign investment is now made by the multinational corporations (MNCs).** These MNCs provide substantial amount of financial resources to the countries where they set up branches and subsidiaries. The capital recipient countries thus get substantial help in meeting their needs of capital for growth. But these countries subsequently face problems when repatriation of profits by MNCs starts or the production plans of these companies start causing distortions in their industrial structure, **Indirect foreign investment takes place when nationals of a country make investments in the shares and debentures of the foreign companies.** At present most of the private foreign investment is made in the direct rather than indirect form.

Foreign aid, refers to official loans and grants given in currency or in kind from developed countries and international financial institutions to less developed countries. These loans and grants are provided for development purposes. In international finance only those loans and grants are relevant which are provided in currency. The chief characteristic of such aid is that it is made available on concessional terms implying that the rate of interest is lower and the maturity period is longer. Foreign aid rarely involves any foreign exchange problems when it is provided. Since aid is given by the developed countries in their own currencies and by the international financial institutions in the currencies of the developed countries, it can be used easily to buy capital equipment and technology in the international markets. However, the problem arises when debt servicing obligations are to be met. For this purpose aid recipient ,countries would need foreign exchange which they can acquire only by having surpluses in their balance of payments. This in most cases is quite difficult to accomplish. As a result most countries inviting foreign capital are now in tight corner. They have either already fallen in the debt trap or are facing the risk of falling into it.

Check Your Progress A

1) State the two main reasons why there is a need for international finance.

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2) State the two main forms in which inter-country long-term capital flows take place.

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3) Which of the following statements are True and which are False :

i) Balance of payments of a country is said to be favourable if its net claims arising from all the transactions with the rest of the world are positive.

ii) Balance of trade refers to the difference between a country's commodity exports and imports.

iii) Balance of payments of a country are always in balance in accounting sense and therefore cannot be in disequilibrium.

iv) Trade deficits or surpluses do not require flow of funds between the countries.

v) Exports and imports of services and the unilateral transfers affect international flow of funds.

vi) Unless capital and current accounts parts of the balance of payments accounts of a country are considered together, one cannot know whether there is a deficit or surplus in its balance of payments.

14.3 FOREIGN EXCHANGE MARKET

Most countries in the present day world have open economies which means that some residents of these countries are engaged in international transactions, These transactions can be in the form of commodity exports and imports, services exports and imports inter-country unilateral transfers, capital flows and exports and imports of gold. Most of these international transactions have one special characteristic which distinguishes them from purely domestic transactions. They require use of foreign currency by the participants in the transaction. For example, an Indian firm importing goods from the USA will have to acquire dollars for meeting payments obligations. Similarly, a Canadian visiting India will have to obtain rupees in exchange of dollars which he may be carrying. The international transactions thus require exchange of one currency for another. This buying and selling of currencies take place in the foreign exchange market.

The term foreign exchange in a norrow sense refers to foreign currencies. In broad sense the term foreign exchange includes not only foreign currencies, but also bank deposits denominated in a foreign currency and short-term claims on foreigners expressed in foreign currencies. Most foreign exchange transactions, however, presently involve purchases and sales of foreign currencies and bank deposits denominated in foreign currencies.

14.3.1 Composition of the Foreign Exchange Market

The main participants in the foreign exchange markets are : 1) retail customers, 2) Commercial banks, **3)** foreign exchange brokers, and 4) central banks.

1) **Retail customers :** Individuals and business firms are the retail customers. They buy and or sell foreign currencies either for transaction purposes or for adjusting their portfolios. The main transaction purposes for which the retail customers. deal in foreign currencies are commodity exports and imports, services exports and imports and buying and selling of securities. Some retail customers participate in the foreign exchange market on a regular basis only to adjust their portfolios i.e., changing the amounts of the various currencies held. Retail customers normally do not transact directly with each other. Their transactions involving buying and selling of foreign currencies are mostly with the commercial banks.

2) **Commercial banks :** The commercial bank is considered to be the most important institution operating in the foreign exchange market. Commercial* banks hold foreign exchange inventories which enable them to transact in foreign

currencies with the retail customers. If a retail customer buys foreign exchange from the bank, the latter's holding of foreign exchange diminishes. Conversely when the retail customer sells foreign exchange, the bank's foreign exchange holdings increase. The process of buying and selling of foreign exchange by the retail customers to commercial banks goes on continuously. It sometimes results in excess foreign exchange reserves with the commercial banks while at other times there may be shortage of foreign exchange with them. Moreover at any given time while some banks may have excess holdings of foreign exchange, the other banks may be facing shortage of foreign exchange. Under these circumstances commercial banks transact in foreign exchange with one another.

3) Foreign exchange brokers : In certain countries the most notable being the USA, commercial banks do not transact in foreign exchange directly with each other. They usually acquire the services of foreign exchange brokers for this purpose. The brokers themselves do not transact in the foreign exchange. Their main function is to bring together the banks which are wanting to buy foreign exchange with those which are wanting to sell it. Therefore the role of the brokers is that of inter-bank intermediaries. While performing this function, the brokers do not bear any risk arising from exchange rate fluctuations. In fact, this risk is borne by the commercial bank which as dealers of foreign exchange are required to hold foreign exchange inventories.

4) Central banks : A country's central bank is an important participant in the foreign exchange market. Its activity is guided mainly by two purposes : i) to support the domestic currency in the foreign exchange market, and ii) to regulate the amount of the country's foreign exchange reserve. However, to achieve its objectives the central bank generally does not operate in the foreign exchange market directly. It often relies on the services of commercial banks and foreign exchange brokers for its transactions in foreign exchange.

14.3.2 Spot and Forward Markets

The foreign exchange market is one of the largest markets in the world. You can imagine the size of this market from the fact that its daily trading volume exceeded $100 billion level in recent years. Foreign exchange markets are often classified as spot markets and forward markets. This distinction is essentially in respect of time of delivery of foreign exchange and payment for it. In spot markets, transactions involving the purchase and sale of foreign currencies are done for immediate delivery. In practice; this often takes one or two days' time, but in no case more than this. The exchange rates used for these transactions are the prevailing exchange rates and are characterised as spot exchange rates. Individuals when they wish to go abroad or want to remit their savings to their native countriesbuy foreign exchange in the spot market. However, for trading purposes buying and selling of foreign exchange in the spot markets may not be entirely safe. Since exchange rates are found to fluctuate over time an importer will have to safeguard his interest against these possibilities by buying foreign exchange in the forward market. Suppose, an Indian firm hopes to receive delivery of goods from an American firm after 30 days. This firm has two options for arranging the payment. First, it buys dollars in the spot market at the time of delivery of the goods. Alternatively, it makes a contract today to buy dollars in 30 days. The first option is risky. Suppose, between the time of placing the order and receiving the delivery the rate of exchange changes in an unexpected manner rising from Rs. 18.00 to Rs. 19.00 per dollar. It can inflict heavy losses on the Indian firm if it had decided to buy dollars in the spot market at the time of the delivery of goods. This loss, however, can be avoided if the Indian firm buys dollars in the forward market for future delivery and payment at a rate of exchange determined today. The importance of the forward exchange market in international finance is great, since most transactions in foreign exchange really involve forward transactions.

14.3.3 Exchange Rate Regimes

In the earlier section, we have referred to spot and forward exchange rates. You must be wondering as to how the exchange rates are determined. Further, why do exchange rates change and is there any system whereby the fluctuations in them can be prevented?

Economists generally distinguish among three basic types of exchange rates regimes. A brief description of these-will provide answers'to the questions posed above. You will learn more about them in Unit 15.

1) **Freely flexible (or free-floating) exchange rate regime** : A system of freely flexible exchange rates is characterised by exchange rates which fluctuate freely in response to demand for and supply of foreign exchange. This system is the least complex of exchange. rate regimes. **The principal advantage of freely flexible exchange rates is that they adjust automatically to secure equilibrium in the balance of payments.** Since freely flexible exchange rate system does not provide for official intervention to support exchange rates, it freely responds to changes in the factors underlying the demand for and supply of foreign exchange. But this also implies that freely flexible exchange rates are highly volatile. Their principal disadvantage is, therefore, that they transmit price instability and thereby discourage trade and reduce economic welfare.

2. **Fixed (or pegged) exchange rate regime** : A fixed exchange rate regime is characterised by a stable exchange rate within well defined narrow limits through official intervention. Under this system exchange rates are not permanently fixed. They can be changed (though not frequently) in response to structural changes which result in persistent balance of payments deficits or surpluses. To begin with, an exchange rate under the **fixed** exchange rate regime is determined keeping in view the balance of payments positions of the countries in question. In fact, it is balance of payments position of a country which decisively determines the demand for and supply of its currency and in turn its value in terms of other currencies. **The main advantage of a fixed exchange rate system is that by providing stability to exchange rate it eliminates a source of uncertainty in international trade.** The main disadvantage of the system is that it makes restoration of equilibrium in balance of payments difficult.

3) **Managed (or controlled) floating exchange rate regime** : Managed floating exchange rate regime refers to a system in which rate of exchange is adjusted through government intervention quite frequently in response to changes in the foreign exchange market. The government, however, does not commit itself to maintaining a certain fixed exchange rate. Its attempt is limited to preventing wild fluctuations in the exchange rate. This policy results in orderly changes in the exchange rate. **The main advantage of this system is that it does not result in large deficits or surpluses in the balance of payments of any country unless it has some structural problems.** It also avoids the uncertainty and volatility of the freely flexible exchange rate system and instability associated with the infrequent adjustments characterising the fixed exchange rates regime.

Check Your Progress B

1) Distinguish between spot and forward exchange markets.

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2) List the main participants in the foreign exchange markets.

i) .....

ii) .....

iii) .....

iv) .....

3) Name the three basic types of exchange rate regimes.

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4) Which of the following statements are 'True and which are False

i) Retail customers generally transact in foreign exchange directly.
iij Commercial bank is the most important participant in the foreign exchange market.
iii) Spot foreign exchange transactions involve immediate delivery of foreign exchange and payment.
iv) In a forward market the price at which currency is traded is set concurrently with the payment and delivery of the currency.
v) A freely flexible exchange rate regime exists whenever exchange rates are freely detennined by the demand for and supply of currencies by private parties.
vi) In a system of fixed exchange rates under no circumstances rates of exchange arc allowed to change.
vii) The system of managed floating is an attempt to combine the advantages of fixed exchange rates with the flexibility sf freely floating exchange rates.

14.4 INTERNATIONAL MONEY AND CAPITAL MARKETS

Money and capital markets are an integral part of any financial system. Their role is quite important in international finance. You rnust be aware that well-developed money and capital markets exist in many world cities, but in major international financial centres like London and New York, they attract funds from all over the world. Therefore, the financial capabilities of the major money and capital markets are great and the funds available with them are used by a variety of domestic and foreign groups on an extensive scale.

14.4.1 Money Markets

A money market refers to a market for transacting in financial assets of relatively short-term maturity. These include demand and time deposits, treasury bills, trade bills, acceptances and a variety of other short-term claims. A **money market provides an outlet for funds to those lenders who wish to keep their financial resources liquid.** For example, people rnaking deposits with the commercial banks can withdraw their money any time. Similarly investments in treasury bills are highly liquid due to their easy marketability. In the absence of a money market, all funds kept in liquid position will remain idle. The money market is of great importance for the borrowers who need funds for a relatively short period, particularly for self-liquidating projects.

Short-term funds are made available in the money market by a variety of domestic and foreign groups among which the most notable are commercial banks, non-bank financial institutions, corporations and other business firms, the central banks, governments and individuals. The demand for short-term funds also comes from these institutions and individuals. Major money markets which have emerged as the international financial centres, are closely integrated with the foreign exchange markets. In these centres a large share of the funds is used for financing the foreign trade and movement of services between the countries.

In the absence of strong exchange control measures, a **money market would be highly sensitive to international differences in interest rates.** If the interest rate is higher abroad, there will be an outflow of short--term funds. However, the extent of such an inter-country flow of short-term funds largely depends on interest rate differentials which should be large enough to offset the cost of currency conversion and forward contracts. A **second factor having considerable bearing on the flow of short-term funds is the degree of external disequilibrium.** Generally short-term funds have a tendency to move from a country with a weak or depreciating currency due to its chronic balance of payments problem to a country with a strong currency. During the post-World War II period, governments of many less developed countries had prevented this flow of funds by resorting to stringent exchange control measures. Finally, domestic disturbance and political instability also results in large outflow of

funds. The flight of capital from many less developed countries in recent year's can be explained only in these terms.

Mobility of short-term funds is generally desirable and is normally stabilising in nature. However, it may not always be so. In case of a country faced with persistent deficit in its balance of payments a large outflow of its funds may prove destabilising. That is why the governments often do not permit sudden international shifting of short-term funds.

A money market acquires international character when there is a worldwide general acceptability and use of the domestic currency of that country to which this market belongs. This confidence in the currency of a particular country results in a situation where these money markets develop as major centres of foreign exchange reserve. Before World War II the London money market was a leading reserve centre. However, its importance as an.international financial centre was weakened due to UK's decline as an economic pbwer. After World War II the New York money market emerged as the leading reserve centre. This was natural due to dollar's convertibility into gold and the supremacy of the USA as an economic power. It is interesting that since many countries hold their reserves in a particular country, the transfer of short-term funds from the former makes the latter a net debtor on the short-term capital account. This in course of time creates the confidence problem in the reserve currency. It actually happened during the early 1970s when the confidence was shaken in dollar and it was exchanged for other strong currencies in huge amounts.

Apart from the central banks of the various countries which hold their foreign exchange reserves in the international reserve centres, commercial banks and business firms also hold short-term claims as working balance against the major reserve centres. The financial institutions at these centres are, well organised and thus always find profitable investment outlets for these funds.

14.4.2 Capital Markets

In contrast to the money market which covers dealings in short-term claims to assets, **the capital market deals in long-term claims to** assets, **such** as **government bonds, and corporate shares and debentures.** In any capital market there are four broad categories of the suppliers of long-term funds : 1) individuals, 2) commercial banks, 3) non-bank financial intermediaries (like insurance companies, investment trusts, unit trusts and pension and provident funds, and 4) development banks. The demand for long-term funds in most countries comes from individuals, unincorporated concerns, business corporations, public corporations and the governments.

Capital rnarkets now exist practically in all those countries where some industrialisation has taken place. However, the major capital markets in the leading industrialised countries have acquired international character. From this point of view the New York capital market now enjoys a unique position. London was the principal capital market in the late eighteenth and the nineteenth centuries. Its importance vis-a-vis the New York capital market has been less in the twentieth century due to the decline of the UK as an economic power.

Inter-country movement of long-term capital is considered to be conducive to a high level of investment and production. The major capital markets which have emerged as the international financial centres channelise long-term investment to countries where they have optimal commercial use. In New York and London, investment banking firms play a significant role in promoting the sale of new foreign securities. They often underwrite the foreign issues. In the USA, the UK and the countries of western Europe, apart from the new issue market for foreign securities, a secondary market for foreign securities also exists. Securities issued by foreign corporations are traded in the stock exchanges and over-the-counter rnarkets of the North American and West European countries.

International movements of long-term capital were restricted by the government of many countries in the post-World War II period. There were two reasons for adopting this policy:

1) On account of the inglorious role of the foreign private investment in the past, many countries with their newly-won independence looked at import of foreign capital with suspicion and thus imposed restrictions on it.

2) Since the foreign private capital was more interested in quick yielding sectors, it was expected to create distortions in the economic structure of the host country.

However, in course of time controls on capital flows were relaxed. Consequently, the flow of long-term private funds between the countries has increased. Since capital flows are guided largely by the amount of returns, more private capital has moved between the various developed countries than from the developed to the developing countries. The explanation for this is simple. Because of very low level of income in developing countries, the size of market tends to be small. The inducement to invest in these countries is, therefore, much less than in the developed countries. Perhaps this explains why the substantial portion of long-term capital flows from developed countries to less developed countries are channelled through government and its agencies.

Check Your Progress C

1) Distinguish between a money market and a capital market.

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2) State which of the following statements are True and which are False:

i) Financial assets of relatively short-term maturity are transacted in a money market.

ii) A money market is generally insensitive to interest rates differentials at the international level.

iii) International mobility of short-term funds is normally stabilising

iv) At present the London money market is the most important reserve centre.

v) In case a country's money market emerges as a leading reserve centre, the country itself will become a net debtor on the short-term capital account.

vi) It is unlikely that the reserve currency will ever face confidence problem.

vii) Long-term claims to assets are transacted in a capital market.

viii) International movement of long-term capital is not conducive to a high level of employment.

ix) Presently the importance of the New York capital market is less.

x) Major capital markets which have emerged as the international financial centres facilitate inter-country movement of long-term capital.

14.5 INTERNATIONAL FINANCIAL INSTITUTIONS

International financial institutions are an important component of the existing international financial system. From this point of view the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD), better known as the World Bank, are particularly important. The decision to set up these institutions was taken at the Bretton Woods Conference held in 1944. In the present section you will learn briefly about their objectives and working. The subsequent units (Units 15 and 16) will deal with these institutions in detail. Presently, the World Bank has two affiliates: 1) the International Development Association (IDA) and 2) the International Finance Corporation (IFC). Although these two institutions have separate existence, yet they have some organisational links with the World Bank and in essence play a complementary role.

14.5.1 The International Monetary Fund

The IMF is now about four and a half decades old. Its main objectives as they are listed in the Articles of Agreement are promotion of international monetary co-operation and international trade in order to realise high levels of income and

employment. From this point of view the IMF would attempt to promote exchange rate stability, discourage adoption of exchange controls, assist member countries to restore equilibrium in balance of payments and develop a multilateral system of payments.

The architects of the IMF were aware that these objectives were difficult to achieve; these were, therefore, considered mainly as guidelines for the general behaviour of the member countries. Ever since the IMF was set up the members of the IMF have found it difficult to eliminate exchange controls. Some countries persistently had deficits in their balance of payments due to structural factors, such as lack of energy resources, basic raw materials, shortage of food etc. These countries in any case cannot remove exchange controls completely. Attempts were made by the IMF to prevent frequent changes in exchange rates for about two and a half decades by recourse to a system of fixed exchange rates. The system of fixed exchange rate, however, broke down when some leading countries in violation of the rules floated their currencies in the early 1970s. Exchange rate stability is no longer an objective of the IMF. The IMF, however, has helped member countries by granting loans from its resources to the member countries to correct temporary maladjustments in their balance of payments. The IMF does not provide funds to any member country for correcting a fundamental disequilibrium in its balance of payments. The objective of developing a multilateral system of payments has always eluded the IMF.

14.5.2 The World Bank

The International Bank for Reconstruction and Development (IBRD), also known as the World Bank, was set up in 1945 as a twin institution of the IMF. It was in fact the first attempt to regulate long-term capital movements among nations in an orderly manner to accomplish some pre-conceived long range plans. Its objectives are: 1) to assist less developed countries in need of capital, 2) to provide resources to countries devastated by war, 3) to facilitate flow of private capital among the countries and 4) to create conditions conducive to international trade between the countries. Thus the architects of the World Bank had set noble goals before it. Notwithstanding the useful services which the World Bank has rendered in facilitating international flow of capital, its activities have invited criticism due to its partisan approach in determining terms and conditions of loans, high rates of interest and bias against less developed countries of Asia and Africa. Most experts now agree that the conservative practices of the World Bank are not always appropriate to the more complex situations of some of the developing countries. The World Bank should have shown greater flexibility and dynamism in channelling funds to these countries.

14.5.3 The Affiliates of the World Bank

The International Development Association (IDA) and the International Finance Corporation (IFC) are the two affiliates of the World Bank. Legally and financially their entities are separate from that of the World Bank.

The International Development Association

The IDA was set up in 1960. The need to set up the IDA was felt long ago. In the late 1940s it was recognised that there was a need for establishing an international agency for financing the development of less developed countries on relatively easy terms. The IDA was set up precisely for this purpose, In fact, its creation highlighted three important points: i) It is a step to institutionalise the concessional finance for development purposes; ii) it has made poverty and economic backwardness in underdeveloped countries a matter of concern for the developed countries of the world; and iii) by improving the economic capabilities of the less developed countries, it attempts to promote a system of multilateral trade and payments.

The membershipof the World Bank is a prerequisite for the membership of the IDA, Any member of the World Bank can join the IDA. However, if he ceases to be a member of the World Bank, its membership of the IDA is automatically terminated, The members of the IDA are divided into two groups, viz., Part I and Part II. Part I countries are the developed ones and Part II are the less developed ones. This categorisation has been made to determine the basis for flow of funds from the richer members to the poorer members of the IDA. Presently, **the IDA is usually referred to as the soft loan window of the World Bank. It underlines the fact that its terms**

and conditions of loans are easy and concessional. The idea underlying the concessional terms and long maturities of the loans given by the IDA is that they should not be burdensome on balance of payments of the borrowing countries.

The International Finance Corporation

The IFC was set up in 1956 to help accelerate economic development of its member countries, particularly in less developed areas by encouraging the growth of productive private enterprise. It thus supplements the activities of the World Bank. In order to realise this purpose the IFC assists productive private enterprise in developing countries in association with private investors. It does not seek guarantee of repayment by the governments of these countries. The IFC also attempts to bring together domestic and foreign private capital and management and tries to create conditions conducive to the flow of private capital, both domestic and foreign, into productive investment in member countries.

The role of the IFC is thus to generate private resaurces for development projects. Left to market forces these resources would not be forthcoming. The IFC promotes productive private investment in three ways: a) by direct investment;b) by obtaining additional foreign and domestic capital; and c) by providing technical assistance. Though the IFC's preference is generally for private enterprise, it sometimes invests in enterprises in which both private and public sectors happen to participate. The IFC, however, invests only in those developing countries where sufficient private capital is not available on reasonable terms.

The membership of the IFC is open only to those countries which are members of the World Bank. If a country ceases to be a member of the World Bank, its membership of IFC terminates automatically.

Check Your Progress D

1) Name the two major international financial institutions.

i) .....

ii) .....

2) Which are the two affiliates of the World Bank?

i) .....

ii) .....

3) State which of the following statements are True and which are False:

i) The IMF mobilises long-term foreign capital for the development projects of the less developed countries.

ii) The IMF has succeeded to an extent in helping the member countries to correct temporary mal adjustments in their balance of payments.

iii) The World Bank provides funds to member countries to correct fundamental disequilibrium in their balance of payments.

iv) The World Bank assists less developed countries in need of capital for their development projects.

v) The IDA provides development aid to less developed countries on concessional terms.

vi) The IFC is usually referred to as the "soft loan window" of the World Bank.

vii) The IFC was set up to further economic development in less developed countries by encouraging the growth of the productive private enterprise.

viii) The membership of the IDA is open to only those countries which are the members of the World,Bank.

14.6 LET US SUM UP

International financial system refers to the system of flow of financial resources among the nations. The need for international financial flows arises from the disequilibrium in the balance of payments of the various countries, the development needs of less developed countries and the desire of the private capital to take

advantage of the investment opportunities abroad. Often transfer of financial resources on account of trade deficits and imbalances in invisible account are short-term. In contrast, capital flows are long-term.

International transfer of financial resources requires use of foreign currency. Currencies of different countries are exchanged for one another with the help of foreign exchange market. The main participants in the foreign exchange markets are retail customers, commercial banks, foreign exchange brokers and central banks. Among these commercial banks are the most important participants. Retail customers do not transact directly. They meet their foreign exchange needs from the commercial banks. The central bank is the overall controller of the foreign exchange market.

Foreign exchange market is one of the largest markets. It is broadly classified into the spot and forward foreign exchange markets. In the spot markets the foreign exchange transactions are done for immediate delivery and payment, while in the forward market the foreign exchange transactions are done for future delivery and payment at a pre-determined rate.

The rate at which one currency is exchanged for another currency is called an exchange rate. For an efficient functioning of the foreign exchange market there has to be some well defined exchange rate system. Broadly there are three basic types of exchange rates systems: i) freely flexible (or freely floating) exchange rate regime; ii) fixed (or pegged) exchange rate regime; and iii) managed (or controlled) floating exchange rate regime.

Money and capital markets play an important role in international finance. A money market is a market in which financial assets of relatively short-term maturity are transacted. Some highly developed money markets have emerged as international financial centres. They are very much sensitive to international differences in interest rates. However, flow of short-term funds among the nations is often influenced by the relative strengths of the various currencies. This flow of funds is generally stabilising in nature. The capital market refers to that segment of the financial market in which long-term claims to assets are exchanged. The major capital markets of the industrially advanced countries channelise long-term investment to countries where profitable opportunities exist for them. This is largely true of the private foreign capital. Long-term loans at the government level, often known as foreign aid, are not channelled through capital markets.

International financial institutions constitute an important component of the international financial system. Presently, the two major international financial institutions are: i) The International Monetary Fund (IMF); and ii) The International Bank for Reconstruction and Development, better known as the World Bank. These institutions have existed for the past four and a half decades. The IMF assists the member countries in tackling their balance of payments problems and thereby encourages international trade. The World Bank provides long-term finance to member countries for the reconstruction and development projects. The World Bank has two affiliates, viz., the International Development Association (IDA), and the International Finance Corporation (IFC). The IDA finances the development programmes of less developed countries on easy terms. The IFC generates private resources for the development projects in the private sector.

14.7 KEY WORDS

Balance of Payments: Difference between the receipts and payments of a country, keeping out accommodating transactions.

Balance of Trade: Difference between commodity exports and imports.

Capital Market: A financial market in which long-term claims to assets are exchaqged.

Disequilibrium in Balance of Payments: A surplus or a deficit in balance of payments.—

Exchange Rate: The rate at which one currency is exchanged for another.

Fixed Exchange Rate Regime: A system of stable exchange rate within well-defined limits.

Foreign Aid: Official loans and grants.

Foreign Exchange: Foreign currencies and bank deposits denominated in foreign currencies.

Foreign Exchange Market: Market in which foreign exchange is transacted.

Forward Foreign Exchange Market: The market in which foreign exchange transactions are done for future delivery arid payment at a pre-determined rate.

Freely Flexible Exchange Rate Regime: A system of exchange, rate in which rates of exchange are allowed to fluctuate freely in response to demand for and supply of foreign exchange.

International Financial System: A system for the Bow of funds between the nations.

Managed Floating Exchange Rate Regime: A system in which rate of exchange is adjusted through government intervention quite frequently in response to changes in demand for and supply of foreign exchange.

Money Market: A market in which financial assets of short-term maturity are transacted.

Spot Foreign Exchange Market: A market in which foreign exchange transactions are done for immediate delivery and payment.

14.8 ANSWERS TO CHECK YOUR PROGRESS

A 2) i) Private Foreign Capital ii) Foreign aid
3) i) True ii) True iii) False iv) False v) True vi) True

B 2) i) Retail Customers ii) Commercial Banks
iii) Foreign Exchange Brokers iv) Central Banks
3) i) Freely flexible (or freely floating) exchange rate regime.
ii) Fixed (or pegged) exchange rate regime.
iii) Managed (or controlled) floating exchange rate regime.
4) i) False ii) True iii) True iv) False v) True vi) False vii) True

C 1) i) True ii) False iii) True iv) False v) True vi) False vii) True
viii) False ix) False x) True

D 1) i) The International Monetary Fund
ii) The World Bank
2) i) The International Development Association
ii) The International Finance Corporation
3) i) False ii) True iii) False iv) True v) True vi) False vii) True
viii) True

14.9 TERMINAL QUESTIONS

1) Discuss the factors from which the need for international finance arises,

2) Explain the paradoxical situation that in spite of the fact that the balance of payments accounts of a country are always in balance, the balance of payments itself is most of the time in disequilibrium.

3) Distinguish between the spot and forward foreign exchange markets. Why are transactions in forward foreign exchange markets done?

4) What are the basic types of exchange rates regimes? Which one in your opinion is the most appropriate for the present day conditions?

5) Discuss the role of money and capital markets in the international flow of funds.

6) What purposes arc being served by the International Monetary Fund and the World Bank and its affiliates?

Note: **These questions** will help you Lo understand the unit better. Try to write **answers fo**r them. But do not submit your answers to the **University for assessment.** These are for your practice only.

UNIT 15 INTERNATIONAL MONETARY FUND

Structure

15.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain the objectives and working of the International Monetary Fund
- Identify the issues involved in the systems of fixed and floating rates of exchange
- Describe the failure of the IMF in ensuring exchange rate stability
- State the problem of international liquidity
- Explain various proposals for raising international liquidity

15.1 INTRODUCTION

In Unit 14 you have leamt that the need for short-term international finance arises due to the problem of disequilibrium in balance of payments. The International Monetary Fund (IMF), which was established in 1944 at Bretton Woods, is considered as the leading international institution which helps its members in overcoming their short-term balance of payments problem. The IMF in the earlier phase of its existence had favoured exchange rate stability because it believed that stability in exchange rate helps both trade and capital movements at the international level, However, if exchange rate stability is overstressed, it often results in unwarranted balance of payments deficits. This actually happened in case of a number of countries making their currencies over-valued. Among these the US dollar was the most important. But the USA was not willing to devalue its currency and bring the exchange rate to its realistic level. Under the circumstances the system of stable exchange rates collapsed in the early 1970s. It got replaced by the system of managed exchange rate floating implying that the rate of exchange would keep on changing in response to changes in foreign exchange markets. This system will normally prevent emergence of a large deficit in the balance of payments of a country unless some structural factors in operation are keeping persistent pressures on its balance of payments position. Apart from systematising the determination of exchange rates, the IMF also works as an important source of international liquidity.

In this unit we shall discuss the objectives and the 'working of the IMF particularly stressing its role in ensuring a rational exchange rate system and adequate amount of international liquidity.

15.2 OBJECTIVES OF THE IMF

The IMF was set up in 1946 as a specialised agency of the United Nations and almost all the non-communist nations of the world are its members (though some communist countries also joined it later).

According to the Articles of Agreement signed by the member countries, the main objectives of the IMF are as follows:

1) to promote international monetary co-operation,
2) to facilitate the expansion of international trade with a view to realise high levels of employment and real income,
3) to promote exchange rate stability and discourage competitive devaluation of currencies,
4) to develop a multilateral international payments system,
5) to eliminate exchange controls over current transactions,
6) to assist member nations to correct balance of payments maladjustments, and
7) to reduce the duration and the severity of balance of payments disequilibrium.

Obviously these objectives are interrelated and aim at helping the member countries to realise economic prosperity by managing their balance of payments freely and efficiently in ways conducive to international harmony. Since competitive exchange depreciation and exchange controls undermine international harmony and are also considered to be affecting international trade adversely, they do not find favour with the IMF. Until the early 1970s the IMF stressed the need for exchange rate stability because it was believed to be a precondition for eliminating a major uncertainty factor in international trade. Of course, if some country persistently had deficits in its balance of payments, it could formally devalue its currency. But in response to its action of devaluation, other countries could not be allowed to indulge in competitive exchange depreciation. In 1973, in spite of endeavour's by IMF the system of Stable exchange rate broke down because the major industrial countries abandoned their exchange rates and floated their currencies. This implied that the exchange rates were to be determined by the prevailing conditions in the foreign exchange markets.

The founders of IMF recognised that if international trade is to be optimised it is necessary to have a multilateral international payments system. Under this payments system direction of foreign trade of a country is not directed by its holdings of particular currencies. This means that if a country holds pound sterlings, it is not necessary that it should import goods and services from the UK only. Under a multilateral payments system, foreign exchange reserves held in any currency can be used for importing goods and services from any country. This is possible because of the free convertibility of the currency. Obviously, it was not easy to develop this system due to the inherent weaknesses of the currencies of the less developed countries. However, the founders of the IMF saw no harm in at least making an attempt in the direction of developing a multilateral payments system.

The IMF has given particular attention to the objective of assisting member nations in overcoming their short-term balance of payments problems. From this point of view the IMF provides a right to its member-countries to 'draw' on its resources to finance a temporary deficit in their current account balance of payments. This arrangement enables member-countries to tide over their balance of payments problems without introducing exchange controls in one form or the other.

15.3 WORKING OF THE IMF

In the working of the IMF three aspects deserve particular attention. These are as follows:

1) Determination of quotas
2) Determination of par values or exchange rates
3) Borrowings from the IMF

15.3.1 Determination of Quotas

The quotas of all the members aggregated to SDR 90 billion in 1989. The Interim Committee of the IMF after reviewing the position in September 1989 had recommended that quotas of the members should be increased on priority basis keeping in view the changes in the world economy and the members' relative position in the world economy. While revising quotas of individual member countries it is necessary to maintain a balance between different groups of countries.

Quotas of the member countries reflect their contribution to the resources of the IMF and provide a basis for determining members' access to these resources and their voting power. Members' shares in allocation of Special Drawing Rights (SDRs) also depend on their quotas. Quotas of the member countries have been determined keeping in view their national incomes, gold and foreign exchange reserves and the volume of international trade. This has naturally resulted in large differences in the quotas of different countries. The largest quota is of the USA which accounts for 20 per cent of the total quota of the IMF. The UK, France, West Germany and Japan are the other leading members of the IMF. They together account for a little more than the US quota. Quotas of the other countries are small and thus in respect of decision making they do not matter much. In fact, the large size of the US quota has given it overriding powers to influence both the policies and practices of IMF.

It needs to be understood that quota of a country has three dimensions:

i) It specifies the amount of contribution of the member-country to the IMF. Of this contribution 25 per cent is to be paid in gold an the remaining 75 per cent in national currency

ii) Country's quota determines the drawing right of a country, i.e., the amount which the country can borrow from the IMF

iii) The quota also determines the voting right of the member countries.

15.3.2 Determination of Par Values or Exchange Rates

Until the system that was conceived at Bretton Woods in 1944 did not break down in the early 1970s, the members of the IMF were under a statutory obligation to declare par values of their currencies in terms of gold control of the US dollar (latter on in terms of SDR). Since this obligation was binding, most countries fulfilled it and declared the par values of their currencies. However, there were some defaulters, but even those countries attempted to maintain de facto parities and thus adhered to the IMF's system of the stable exchange rates often characterised as the system of pegged exchange rates.

Member-countries had transactions with the IMF at the official per values. Only these exchange rates were to be used even for private transactions. For spot transactions deviation from the par value in the range of 1 per cent was allowed. In December 1971 the Smithsonian Agreement widened this range to 2.25 per cent above or below the par value. This obviously suggests that the founders of the IMF in their wisdom thought that the stable exchange rates regime was conducive to both international trade and international flow of capital.

In the earlier phase that lasted for more than two and a half decades the member countries had the right to change the par values of their currencies in the range of 10 per cent by simply intimating the IMF. However, for changes in the exchange rates exceeding 10 per cent, approval of the IMF was necessary. These changes were allowed whenever they were required for correcting fundamental disequilibrium in the balance of payments. Hence the IMF never stressed upon exchange rate rigidity, though it always sought to promote exchange rate stability.

Although at the end of the 1960s the dollar was losing prestige, due to persistent deficits in the USA's balance of payments yet there was no crisis of confidence in it.

However, when on August 15, 1971 the US government announced that it would no longer redeem dollars from other central banks for gold or other reserve assets, the demand for the currencies of various European countries increased and people wanted to get rid of their dollar holdings. In this situation the earlier stable exchange rate system of the IMF became unworkable. A number of countries refused to support their parities, allowing their currencies to float upward. For about four years attempts were made to revive the earlier system but without success. Finally in January 1976 the issue was resolved by legalising the managed float. The IMF has not adopted formal rules for managed floating and therefore rates of exchange keep on fluctuating in response to changes in foreign exchange markets. This implies that if some country persists with deficits in its balance of payments, its currency will inevitably depreciate. Therefore, it is necessary that the balance of payments of the country must be kept in order.

15.3.3 Borrowings from the IMF

As explained earlier in this unit, the IMF aims at helping its members to overcome their balance of payments problems of temporary nature. From this point of view it sells those currencies to the member countries which they need for meeting their short-term debt obligations. These exchange transactions between the IMF and its members are not ordinary transactions involving buying and selling of currencies. In essence they are borrowings of the other countries' currencies by the member-countries from the IMF though the borrowers are required to give their own currencies in exchange of the foreign currencies from the IMF. The borrowers are required to pay interest which increases with the amount and the duration of borrowings. The repayment of loan involves repurchase of one's own currency by making payment in gold or in the currency in which the loan was originally taken.

A member-country, however, cannot get Ioans from the IMF in unlimited quantity. In this regard there are two restrictions: First, the IMF will not normally hold a country's currency in an amount exceeding 200 per cent of its quota. This means that in a normal case the total borrowings of a country from the IMF will not exceed 125 per cent of its quota. This condition can however be waived by the IMF in special cases. Second, the borrowings from the IMF by a country should not raise the Fund's holdings of the latter's currency by more than 25 per cent of its quota during a one year-period ending on the date of borrowing.

The right to borrow or draw foreign currencies from the IMF enables member-countries to tackle their short-run balance of payments problems without recourse to bilateral balancing of transactions. In a multilateral payments system which the IMF is waning to strengthen, the member-countries would not seek loans in currencies of only those countries wit11 which they have bilateral deficits. In fact, in such a system loans in any foreign currency will be good enough to meet debt obligations. In practice, the IMF has yet to evolve a multilateral payments system. Hence most of the time IMF is approached by the member-countlies to seek loans in particular currencies due to their wider acceptability.

Check Your Progress A

1) What is the International Monetary Fund?

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2) List the various dimensions related to the country's quota allotted by the IME

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3) What are the main aspects of working of the IMF?

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4) Which of the following statements are True and which are False:

i) The IMF in the earlier phase of its existence had stressed exchange rate stability.

ii) After the break down of the earlier IMF system the new system that has emerged is known as the fluctuating exchange rate system.

iii) The decision to set up the IMF was taken at the conference held at the Bretton Woods.

iv) Exchange controls are necessary for the international harmony.

v) Quotas of all the members of the IMF are not the same, and therefore the voting rights of the members are also different.

vi) Members of the IMF borrow funds from it for financing their development projects.

vii) Members of the IMF can borrow from it in unlimited quantity to meet their debt obligations arising from the deficits in their balance of payments.

viii) In a multilateral system of payments the members of the IMF would not seek loans from it in currencies of only those countries with which they may have bilateral deficits.

15.4 EXCHANGE RATE STABILITY VERSUS MANAGED FLOAT

For a long time economists were convinced that the system of fixed exchange rates was preferable to a system of fluctuating exchange rates. As stated earlier in this unit, this was also the view of the founders of the IMF. They had therefore provided for a system of stable exchange rates. However, under changed circumstances, adjustment could be formally made in the exchange rates. This system was known as adjustable peg regime. This system broke down in the 1970s giving way to a new system known as, the system of managed float.

15.4.1 Adjustable-peg System

The adjustable-peg system of exchange rates which was adopted by the IMF at the Bretton Woods Conference (often called the Bretton Woods system) continued for about two and a half decades. It was believed to be having the following merits:

1) **Eliminates uncertainties of foreign trade:** International trade is beneficial to all the participating countries and, therefore, everything possible must be done to encourage it. However, international trade involves two problems which are not there in domestic trade. First, for making payments the importer needs to obtain the necessary foreign exchange as the domestic currency will not be of any use to him. A fluctuating exchange rate upsets his plans and calculations of obtaining foreign exchange for imports. Secondly, if the rate of exchange keeps on fluctuating in an erratic manner, it can also upset the importer's calculations with regard to his profits. Hence the rate of exchange should be relatively stable. The IMF system of adjustable-peg was expected to tackle this problem.

2) **Facilitates inter-country flow of private capital:** Although in modem world international flow of capital is not decided entirely on economic considerations, the inter-country movement of private capital surely takes into account the relevant economic factors. Among these an important factor is the absence of uncertainties associated with fluctuations in the exchange rate. Fluctuations in exchange rate create conditions in which large capital losses cannot be ruled out. This naturally deters inter-country movement of foreign private capital. The adjustable-peg system of exchange rate, which prevailed till the seventies created conditions conducive to inter-country flow of foreign private capital by eliminating uncertainties caused by possible fluctuations in exchange rates.

3) **Prevents speculation in foreign exchange:** Theoretically it is possible to argue that speculation in foreign exchange has a tendency to smooth out fluctuations in

the exchange rate caused by trade and has thus a stabilising effect. In practice, however, the experience of speculation in foreign exchange is not very encouraging, as it has invariably contributed to unwarranted fluctuations in the rates of exchange. Freely flexible exchange rates provide much scope for speculation in foreign exchange, while adjustable-peg regime of the IMF provided little scope for such speculation as the exchange rates were by and large fixed.

4) Checks **import of inflation**: When a currency depreciates, it increases the prices of imported goods and services, resulting in a rise in the prices of domestic goods and services. Due to persistent deficits in their balance of payments, the currencies of most of the developing countries have a tendency to depreciate over time in a flexible exchange rates system, these countries fail to avert import of inflationary pressures. However, under adjustable-peg regime the stable exchange rates help by insulating an economy from the possible import of inflation resulting from continuous fall in the external value of the country's currency.

15.4.2 Failure of the IMF

The adjustable-peg regime broke down in the 1970s, underlining the failure of the IMF. One important factor which contributed to the system's collapse was inflation in the USA caused by the wrong policies of the government to finance the Vietnam War. This inflation resulted in deficit in balance of payments of the USA. On the other hand, at this juncture, there were certain countries of Europe which were having surplus in their balance of payments. These countries were unhappy with these developments. They were keen to prevent import of possible inflation from the USA. In 1971 the prevailing conditions encouraged speculation in foreign exchange. Since dollar at this point of time was overvalued and the US government was unwilling to devalue it, speculators became more and more anxious to change dollars into German marks. In the first week of May 1971 there was large trading in marks and dollars and in three days $2 billion were exchanged for marks. Since further trading could have serious repercussions on the German economy, it was suspended and the Frankfurt foreign exchange market was closed. When the foreign exchange market reopened the following week, Germany allowed the mark to float contrary to the statutory provisions of the IMF. At this juncture Australian shilling and Swiss Franc were revalued. However, the deficit in the US balance of payments continued. to increase. There was massive outflow of both short-and long-term capital from the USA. The speculation against dollar persisted and the confidence in it was greatly shaken. In spite of these developments the USA's approach was not to devalue the over-valued dollar. This made the matter worse. The central banks of major countries in this situation failed to stave off speculation against dollar. The integration of the world economy in general and of the financial markets in particular had exposed the system to speculation and certain other types of disturbances. Multinational firms moved large funds around in pursuit of short-term gains. Unable to sustain all these pressures the IMF system as conceived at Bretton Woods finally collapsed. According to the experts, August 15, 1971 the day when the USA formally abandoned the convertibility of dollar into gold actually marks the demise of the Bretton Woods system.

Let us now attempt to understand whether there was any basic defect in the Bretton Woods system or it was some unexpected chance development that caused its break down. Most experts now believe that undue stress on exchange rate stability and reluctance on the part of the leading developed countries to devalue their currencies for correcting balance of payments disequilibrium were the two most important reasons for the collapse of the Bretton Woods system. The system was based on the presumption that the parities of major currencies would be maintained and in any case the exchange rate of dollar would persist unaltered. This implied that in no situation the dollar would be devalued and that no other major currencies would be revalued. This is evident from the fact that except for the 1949 adjustments the industrial countries accounted for fewer than ten exchange rates adjustments between 1945 and 1971. The US government adopted the attitude of total casualness to the persisting deficits in its balance of payments and the consequent outflow of dollar. This situation would have caused no anxiety had the US remained the natural leader ..of the Western World. But this was not to be. The world inflation transmitted from

the USA in the late 1960s shook the confidence of IMF members in the Bretton Woods system. Consequently, there was a drift from the adjustable peg regime. The Bretton Woods system no doubt failed but the working of the IMF taught the leading developed countries that there are certain benefits of international monetary co-operation.

15.4.3 The System of Managed Float

Some leading economists, like J.E. Meade, H.G. Johnson and M. Friedman have advocated adoption of a system of flexible exchange rates. In their opinion, in a system of flexible exchange rates there is a continuous process of adjustment. Compared to this, in a system of fixed exchange rate, adjustments in exchange rate are under-taken only under situations of crisis. Obviously, this rnakes the system of flexible exchange rates preferable to the system of fixed exchange rate. The system of flexible exchange rate removes pressure on the government to intervene in international trade for restoring equilibrium in balance of payments. It also gives freedom to governments to use instruments of domestic policy exclusively for the pursuits of domestic objectives. Further, when flexible exchange rates are used as instruments of adjustment, the need for assets that could be used for meeting international payments obligations is very much reduced.

However. the experiences of flexible exchange rates system (or free floating) are not very encouraging. Immediately after the collapse of the Bretton Woods system the world witnessed highly destabilising swings in the exchange rates of major currencies. These swings in exchange rates rarely reflected the basic economic situations of the countries concerned. They, in fact, were often caused by the speculative activities in the foreign exchange market. Hence, a completely flexible exchange rates system was ruled out. Rather, a system of managed floating is found far more conducive to international trade and capital rnovemcnts in the existing international monetary situation. In this system various forms of co-operation and management are required. After the break down of adjustable-peg regime when the new system of managed float was emerging one could easily see the European countries cooperating among themselves under the 'snake scheme'. The snake scheme provided for the joint float of the currencies of the European Economic Community (EEC) countries, i.e., West Germany, France, Belgium, Netherlands, Luxemburg and Denmark. Though not members of the EEC, Sweden and Norway joined the common EEC float. You have learnt earlier in this unit that under the Smithsonian agreement a currency could fluctuate 2.25 per cent around its central rate. 'Therefore, in 1972 the EEC countries decided to tie their currencies together and limit fluctuations in their exchange rates within this narrow limit. This arrangement was known as "the snake in the tunnel" After March 1973 the EEC currencies though remained tied together, there was no restriction on the amount of change in par values relative to other currencies. The new arrangement was called "the snake in the lake". It should be noted that right from the beginning in 1973 the UK, Italy and Ireland were not party to the joint float. France disassociated itself from the 'snake arrangement' in 1974, Sweden left it in 1977 and Norway in 1978. However, the way the common EEC float was operated it can be safely concluded that the managed float does not permit completely free fluctuations of exchange rates, and therefore does not involve the risk of complete disorder in the system of exchange rates.

The floating exchange rates system can be managed in various manners. However, two proposals in this regard desenre particular attention. Since the managed float approach is based on the idea of the 'normal' price implying that the exchange rate should fluctuate around some equilibrium value, (in case of drift of the actual exchange rate from this equilibrium value) the central bank of the concerned country will intervene in the foreign exchange market. One proposal for intervention suggests that when the central bank intervenes it should not contribute to swings in the exchange rate. In fact its attempt should be to moderate the swings. Therefore, no central bank should sell its currency when the exchange rate depreciates, nor should it buy its currency when its price rises. According to a second proposal, a system of reference exchange rates should be evolved. These reference rates should be periodically revised and should not deviate much from the equilibrium values of the currencies. The rule for managing the exchange rates is that no central bank should sell its currency at *a* price below the reference rate and it should not buy its currency at a pride above the reference rate.

The system of managed float apparently looks similar to an adjustable-peg system. In reality the two systems are different. Under the managed float system there is virtually no bias towards rigidity as it permits constant adjustment of rate of exchange. In contrast, the adjustable-peg system invariably delays adjustments and, therefore, eventually needs relatively large changes in the exchange rates.

Check Your Progress B

1) Describe the Bretton Woods system of adjustable-peg.

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2) Distinguish between managed float and free float.

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3) Which of the following statements are True and which are False:

i) The adjustable-peg system of exchange rates facilitates inter-country flow of private capital.

ii) In a system of freely fluctuating exchange rates uncertainties of foreign trade are completely eliminated.

iii) So long the adjustable-peg system worked well, it did not leave much scope for speculation in foreign exchange.

iv) The adjustable-pcg system was not expected to provide a safety valve against import of inflation.

v) The IMF system of stable exchange rates broke down because the dollar appreciated in value.

vi) Undue stress on exchange rate stability and reluctance on the part of leading developed countries lo devalue their currencies even when they had deficits in balance of payments caused the collapse of the Bretton Woods system.

vii) A completely flexible exchange rates system or free floating is preferable to managed float because of its merit of constant adjustment.

viii) The "snake scheme" provided for the joint float of the dollar and the pound sterling.

ix) The central bank's intervention in the foreign market under the managed float should contribute to swings in the exchange rate.

15.5 THE IMF AND INTERNATIONAL LIQUIDITY

The term 'international liquidity' usually refers to gold and foreign exchange reserves position at the international level. In September 1967, the Board of Governors of the IMF at their Annual meeting at Rio De Janeiro decided to create a new reserve asset in the form of Special Drawing Rights (SDRs) for meeting steadily increasing demand for international liquidity. Since then the demand for international liquidity emanating from deficits in the balance of payments is met from three sources: (i) the official gold and foreign exchange reserves of the various countries, (2) gold and foreign exchange reserves with the IMF and (3) the SDRs. In this section; you will first study the problem of international liquidity followed by a brief discussion of some important proposals for increasing international liquidity. Since creation of the SDRs by the IMF has been the most radical measure since World War II to augment the international liquidity, it will be explained separately in this section in the end. the end.

15.5.1 The Problem of International Liquidity.

After World War II the importance of pound sterling declined and the US dollar emerged as the most widely acceptable currency at the international level. Since dollar was convertible into gold, most countries wanted to hold their foreign exchange reserves in dollars. The supply of dollars depended on the amount of deficits in the US balance of payments. In addition to dollar reserves of the various countries the IMF's reserves also constituted international liquidity. This system of creation of international liquidity was haphazard and thus the rate at which the international liquidity grew during the 1950s was erratic. This disturbed various economists. Robert Triffin one of the most distinguished economists of the late 1950s, felt that the international liquidity was growing too slowly considering the rate of growth of world trade. The trade had grown at the rate of 7.5 per cent per annum, while gold reserves had grown at 1.4 per cent per year and overall international liquidity had increased at the rate of only 2.7 per cent per annum. Further, the distribution of foreign exchange and gold reserves among the various countries was uneven. However, the most serious aspect of the problem was that there was no built-in mechanism whereby an orderly increase in the international liquidity could be possible.

Under the IMF system attempts to increase the supply of gold at the desired rate were scuttled by the USA. When the IMF was established the price of gold was fixed at $35 per ounce. It could not be revised upward for 28 years due to the US opposition. As a result neither the producers of gold had the incentive to increase the supply of gold, nor the countries holding large stocks of gold were prepared to release them for monetary use. The dollar reserves, however, increased in a big way because the USA had large deficits in its balance of payments. During the 1950s, dollars were considered as good as gold due to their convertibility into gold. In the late 1950s when the fact of persistent huge deficits in the US balance of payments attracted attention of some west European countries there was great pressure on the USA to ,convertdollars into gold. This caused flow of gold from the USA to Europe. As a result the US share in the official stock of gold declined rapidly and the dollar's convertibility into gold became suspect. The confidence in the dollar was on the decline and further deficits in the US balance of payments did more damage to prestige of the dollar. In this situation further growth of international liquidity became difficult.

The problem of international liquidity is also linked with the exchange rate pegging. As discussed in Section 15.4.3 of this unit, in a system of flexible exchange rates there would be much less demand for international liquidity and that would not be difficult to meet from the given foreign exchange reserves. Hence, the pressure on augmenting the supply of international liquidity has diminished much ever since the Bretton Woods system of adjustable peg has been replaced by the system of the managed float.

15.5.2 Proposals for Raising International Liquidity

Having noted that the international liquidity was not increasing at the required rate some economists and other experts made both radical and reformist proposals in order to tackle the problem of international liquidity. Among the radical proposals two were most important. One of these proposals was that the system of adjustable peg should be abandoned and in its place the flexible exchange rates system should be adopted. This would obviously reduce the demand for international liquidity and the existing foreign exchange reserves could easily meet this reduced demand for international liquidity. In the early 1970s the world finally switched over to a system which is in essence a variant of the flexible exchange rates system. The other radical proposal was for reviving the gold standard of pre-World War II period. This was considered unworkable and thus lacked much support. The reformist proposals sought to increase the international liquidity in the JMF system itself. Among these the following proposals received much attention, but for various reasons could not be adopted. Nonetheless they merit brief discussion.

1) **Raising the price of gold**: During the 1950s and 1960s some experts, including Roy Harrod and Jacques Rueff, Economic Adviser to President de Gaulle of France recommended that the price of gold which was pegged at $ 35 per

ounce should be raised. In their opinion, this price was unrealistic and was discouraging gold supply to increase, thus creating shortage of international liquidity. However, such a scheme was found to have its share of shortcomings. An upward revision in the price of gold could induce speculation in gold which was not considered a desirable development. The possibility of flights from national currencies to gold could also not be ruled out. If that was to happen, the national currencies could not be used as international reserves. Probably on account of these considerations the USA and some other leading industrial countries never favoured the idea of raising the price of gold though it could help in tackling the problem of international liquidity.

2) **The Triffin Plan :** Robert Triffin recommended that the centralisation of foreign exchange reserves was necessary for tackling the problem of international liquidity. In his opinion, a system based on one or two reserve currencies was very fragile, because any attempt to augment the supply of international liquidity by increasing their supply could impair confidence in them. It actually happened in case of the dollar. Triffin, therefore, proposed that the IMF should assume the character of the central banks and the members of the IMF should be asked to deposit their foreign exchange reserves with it. Triffin was aware of the fact that most countries would not like to surrender their foreign exchange reserves to the IMF as it would amount to compromising on their economic freedom. He thus suggested that to begin with the members of the IMF could provide around 20 per cent of their foreign exchange to augment the supply of international liquidity. The Triffin Plan being utopian was not considered to be practicable and thus did not receive wider support. Hence no attempt was made to adopt it.

3) **The Bernstein Plan :** E.M. Bernstein was associated with the IMF. He had put forward aproposal that could be carried out in the basic framework of the IMF. There were two main aspects of the Bernstein Plan. First, it recommended that the IMF quotas of each country should be integrated with its official reserves. This arrangement would have made the access of the members of the IMF to its foreign exchange reserves automatic. The second proposal was with respect to creating a Reserve Unit Account in the IMF. The members of the IMF by subscribing to Reserve Unit Account could create additional reserves. The Bernstein Plan, like other proposals tried to augment international liquidity failed to get adequate support and was thus not adopted. The chief weakness of the Bernstein Plan was that it offered little to tackle confidence problem which in fact was at the heart of the problem of shortage of international liquidity.

15.5.3 Role of Special Drawing Wights

In 1969 the Board of Governors of the IMF at their annual meeting decided to create a new reserve asset, Special Drawing Rights (SDRs) to meet the growing demand for international liquidity. In order to implement this decision the Articles of Agreement of the IMF was amended in 1967. The allocations of SDRs aggregating 9.3 billion were done in 1970, 1971 and 1972. Thereafter for seven years there were no allocation of SDRs. The 1979 fresh allocations of SDRs totalling 12 billion began. This allocation process was completed in three years. Physically, SDRs are simply book-keeping entries at the IMF in accounts of member-countries and the IMF itself. The SDRs are not usable like national currencies. They are to be first exchanged for national currencies with other central banks and the IMF before a country can use them for meeting its payments obligations.

Since SDRs are created to supplement the existing international reserve assets out of nothing, great caution is needed in their creation. Any proposal to create SDRs must have the approval of the IMF members enjoying at least 85 per cent of the voting power. Therefore, a proposal to create SDRs can be scuttled by the USA alone which has 20 per cent voting power or by the EEC countries which together have votes exceeding 15 per cent of the total votes. SDRs have been allocated to the members of the IMF in proportion to their quotas. Therefore, the benefit of the creation of SDRs has gone largely to the developed countries whose quotas are much larger than the quotas of the less developed countries. The proposal of the' developing countries to allocate SDRs to the members of the IMF on the basis of economic backwardness was not accepted due to lack of adequate support.

When the SDRs were first created in the early 1970s their value was fixed in gold;

one SDR equalling 0.888671 gram of fine gold. Since this was also the value of the dollar one SDR became equal to one dollar. With the devaluation of the dollar in 1971 and 1973 the one-to-one relationship between the SDR and dollar was disturbed. Later *m*, with the decline in the importance of gold in the IMF system, the value of SDR was fixed on the basis of a currency basket. Presently, the basket is composed of the currencies of the world's five largest exporting countries. The weights of the currencies of these countries in the basket are: the US Dollar 42 per cent, Deutsche Mark 19 per cent, French Franc, Pound Sterling and Japanese Yen 13 per cent each.

SDRs can be lased by a country to finance its balance of payments deficits. As stated earlier in this unit, SDRs are not directly usable. Therefore, a needy country will have to obtain the required currency by exchanging SDRs for it. As a result, SDR holdings of the country providing the required currency will increase, while those of the country which transfers SDRs will diminish. **A country facing no balance of payments problem is not allowed to draw SDRs from the IMF with a view to exchange them for national currencies.** In other words, the members of the IMF are not expected to use SDRs for changing the composition of their reserves but only for meeting temporary disequilibrium in their balance of payments.

It might be useful to compare the importance of SDRs with that of gold and **foreign exchange** reserves. Presently, SDRs total around $25 billion, while the international Liquidity is estimated to total $500 billion. Therefore, SDRs account for hardly 5 per cent of the international liquidity. When the IMF declares that in future SDRs will become the principal reserve asset, it is actually a statement of intentions rather than a reflection of existing facts. Many experts are convinced that these intentions in future also will not be translated into reality. In their opinion, SDRs suffer from some basic **problems** which cannot be easily overcome. First, SDRs cannot be used as an intervention currency. Secondly, there is no mechanism whereby SDRs can be created in response to increased demand for international liquidity. Finally, the veto power which the USA presently enjoys on the basis of its voting strength can always scuttle any proposal to create fresh SDRs, if it conflicts with the national interests of this country.

Check Your Progress C

1) List the reserve assets which presently constitute the international liquidity.

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2) Fill in the blanks:

i) The unique reserve asset created by the IMF is ..... .

ii) In a system of adjustable peg, since exchange rate did not change too often demand for international liquidity ..... rapidly.

iii) Under the Triffin Plan there was stress on ..... of foreign exchange reserves.

iv) Roy Harred had recommended ..... revision in the price of gold with a view to augment the supply of gold.

v) Physically, SDRs are simply ..... entries at the IMF in accounts of member countries.

3) Which of the following statements are True and which are False:

i) The demand for international liquidity emanates from disequilibrium in the balance of payments of a country,.

ii) Since the World War II pound sterling has emerged as the most widely acceptable currency at the international level.

iii) Upward revision in the official price of gold could augment its supply and thereby could ease the problem of international liquidity.,

iv) Large surpluses in the US balance of payments during the 1950s and 1960s resulted in considerable increase in the supply of dollars which could be used as reserve assets.

v) SDRs are presently the biggest component of the international'liquidity.

vi) . SDRs arc directly usable for meeting payments obligations at the international level.

15.6 LET US SUM UP

The International Monetary Fund (IMF) has existed for rnore than four decades. It has promoted international rnonelaryco-operation, facilitated international trade and assisted member-countries to correct their balance of payments disequilibria. The IMF has, however, failed to eliminate exchange controls. It attempted to promote exchange rate stability, but the system of adjustable-peg which was expected to serve this purpose finally broke down in the early 1970s.

In the working of the IMF the relevant aspects are i) determination of the quotas of the member-countries, ii) determination of the par values or exchange rates, and iii) borrowings by the member-countries from the IMF. The quotas of all the member-countries taken together presently amount to SDR 90 billion. The quotas of individual countries reflect their comribution to the resources of the IMF and have been fixed keeping in view their national incomes, reserve assets and volumes of foreign trade. The quotas also determine the voting powers and drawing limits of the member-countries. The IMF assists the mernber-countries in overcoming their short-term balance of payments problems. For this the members are allowed to borrow form the IMF within statutory Emits.

Until the early 1970s, the par values or the exchange rates in the IMF system were determined in terms of the national currencies' parity with gold. In case of fundamental disequilibrium in the balance of payments of a country it could revise the value of its currency in terms of the other currencies and gold. However, competitive exchange depreciation was not allowed. The original IMF system known as the Rretton Woods system stressed the exchange rates stabilty.

From this point of view the system of adjustable peg was adopted. Under this arrangement the exchange rate could be altered only if it was so warranted by the fundamental disequilibrium in the balance of payments of the country concerned. This system eliminated uncertainties of foreign trade, facilitated inter-country flow of private capital, prevented speculation in foreign exchange and acted as a safety valve against import of inflation.

The adjustable-peg system, however, broke down in the 1970s underlining the failure of the IMF. The failure was caused by persistent deficits in the USA's balance of payments which undermined confidence in the dollar. As a result, devaluation of the dollar became necessary. The USA resisted pressure to devalue the dollar for some time and abandoned the convertibility of the dollar into gold, Under these circumstances some leading European countries decided to float their currencies and in the process the dollar was depreciated. Thus, adjustable-peg system gave place to a new system called the system of managed float. On theoretical grounds some economists favour flexible exchange rate to the system of managed float. But in practice the former has been found highly destabilising, while the latter involves co-operation among countries to systematically revise exchange rates continuously thus not permitting free fluctuations in exchange rate. It is for this reason that the system of managed float was adopted by these countries.

The balance of payments disequilibrium and lack of multilateralism create demand for international liquidity. The demand for international liquidity is presently met from three sources, viz., the official gold and foreign exchange reserves of the various countries, gold and foreign exchange reserves with the IMF, and the SDRs. After World War II the supply of international liquidity has not increased as fast as the demand for it. The persistent deficits in the USA's balance of payments though

augmented the supply of the international liquidity, it created the problem of crisis of confidence in the dollar. Hence, Robert Triffin, E.M. Bernstein and Roy Harrod put forward proposals to tackle the problem of international liquidity. These proposals however were not adopted. To meet growing demands for the international liquidity the IMF has created a new reserve asset called the Special Drawing Rights (SDRs). In essence SDRs are only book-keeping entries at the IMF in accounts of member countries and the IMF itself. They are not directly usable. They have to be converted into national currencies, before they can be used for meeting foreign debt obligations. SDRs have been created in small quantities and have been allocated to member countries in direct proportion to their quotas. Presently SDRs account for about 5 per cent of the international liquidity. The value of SDRs has been fixed on the basis of a currency basket which is composed of the currencies of the world's five largest exporting countries.

15.7 KEY WORDS

Adjustable-peg Regime : A system of stable exchange rates with the provision for adjustments in cases of fundamental disequilibrium in balance of payments.

Bretton Woods System: The system of stable exchange rates in the IMF framework as adopted at the conference held at Bretton Woods in 1944.

Devaluation : Reduction in the external value of the currency in terms of gold and/or some foreign currency.

Exchange Control : A system under which foreign exchange transactions are subject to government control.

Exchange Rate : Value of a currency in terms of some other currency.

Fixed Exchange Rate: Rate of exchange that does not change.

Flexible **Exchange Rate** : Rate of exchange which continuously keeps on adjusting with changing conditions.

Free Float : A system under which rate of exchange fluctuates freely.

International Liquidity : Reserve assets position at the international level.

Managed Float : A flexible system of exchange rates under which exchange rates adjustments are collectively made.

Multilateral Payments : A payments system at the international level under which any country's currency can be used for making payments to all other countries.

Par Values : Exchange rates..

Special Drawing Rights: A reserve asset created by the IMF.

15.8 ANSWERS TO CHECK YOUR PROGRESS

A) 4) i) True ii) False iii) True iv) False v) True vi) False vii) False viii) True

B) 3) i) True ii) False iii) True iv) False y) False vi) True vii) False viii) False ix) False

C) 2) i) SDRs ii) rose iii) centralisation iv) upward v) book keeping
3) i) True ii) False iii) True iv) True v) False vi) False

15.9 TERMINAL QUESTIONS

1) What are the various objectives of the International Monetary Fund? How far they have not been realised?

2) Describe the working of the IMF. How does it help member countries in dealing with their temporary balance of payments problems?

3) What is meant by the adjustable-peg regime'? Why did it fail?

4) Explain the circumstances in which the world has switched over to the system of managed float.

5) What is international liquidity? Discuss various proposals to augment the supply of international liquidity.

6) What are the Special Drawing Rights? Wow far has their creation solved the blem problem of international. liquidity?

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.

UNIT 16 WORLD BANK

Structure

16.0 OBJECTIVES

After studying this unit, you should be able to:

- Describe the objectives of the World Bank
- Explain the various functions of the World Bank
- Discuss the role of the World Bank as the mobiliser of resources for reconstruction and development
- Describe the operations of the World Bank and identify the problem associated with its operations
- Explain the contribution of the World Bank
- Identify the failures of the World Bank,

16.1 INTRODUCTION

The International Bank for Reconstruction and Development (IBRD), often referred to as the World Bank, was set up as a sister organisation of the International Monetary' Fund. The decision to create IBRD was taken at the Bretton Woods Conference in 1944. The World Bank started its operations in 1946. Its main purpose was to promote the long-term foreign investment to help in transforming War devastated economies and to encourage less developed economies to accelerate the pace of their development. Obviously the activities of the World Bank were to remain confined to assisting only the member countries. In this unit you will study the objectives, functions, operations and performance of the World Bank.

16.2 OBJECTIVES OF THE WORLD BANK

The objectives of the World Bank have been clearly stated in the **Articles of Agreement.** These are as follows:

1) **Financing reconstruction of the war-devastated economies: During World** War II many countries of Europe had suffered heavily in terms of the destruction

of their infrastructure and industries. The economies of these countries were in bad shape and could not generate adequate resources internally for the reconstruction work. Even the flow of private foreign capital to these countries was not certain. Of course some foreign aid was expected from the USA, as this was the only developed country which had escaped the destruction from the war. But it was not enough. Keeping these realities in view, it was decided at the Bretton Woods Conference that the World Bank would provide finance for the reconstruction of the war-devastated economies.

2) **Financing development of economically backward countries:** By the time the Bretton Woods Conference was held, it had become clear that in the post-World War II period economically backward countries having inadequate domestic resources would need considerable amount of private foreign capital as well as foreign aid to tread on the path of economic development. Given the requirements of resources of these countries both these sources of external finance were likely to be inadequate and uncertain. The World Bank was thus expected to provide long-term financial help for development projects in underdeveloped countries. However, considering the capital requirements of these countries, the resources of the World Bank were meagre in the beginning and continue to remain so even till today.

3) **Promotion of private foreign investment:** At the time of Bretton Woods Conference, international credit structure was in shambles because the principles of sound international private lending were not followed between World War I and World War II. Foreign loans were obtained for aon-viable projects, sometimes at exorbitant rates of interest. Short-term credits were used for long-term investment purposes creating repayment problems. In the light of these experiences it was unlikely that private foreign capital would be freely available for reconstruction and development projects. Even if some private foreign capital was available, its terms being highly unfavourable, it was not expected to be allocated according to sound economic principles. This called for a system whereby flow of private foreign capital could be promoted. The World Bank was thus entrusted with the task of promoting private foreign investment by means of guarantees or participations in loans and other investment made by private investors. The World Bank was not to replace the flow of private foreign capital; it was only to provide finance for productive purposes on appropriate terms and conditions when private foreign capital is not available at reasonable terms.

4) **Promotion of long-term balanced growth of international trade:** It is generally agreed that international trade is beneficial to all the participants in it. Therefore. balanced growth of international trade should be encouraged. In a highly unevenly developed world the prospects of balanced growth of international trade would be dim. Hence, it was rightly conceived by the architects of the World Bank that less developed economies should overcome their structural handicaps by developing their productive resources and acquire export capabilities. This would help them in maintaining equilibrium in balance of payments while their quantum of foreign trade increases. However, economically backward economies could not accomplish this task on their own. They had to be assisted in realising this objective. The World Bank, keeping this reality in view encourages international investment in developing countries.

5) **Assisting member countries in bringing about an easy transition from a war time economy to a peace time economy:** During World War II economies of most countries were consciously oriented to the requirements of the war, Therefore, there was considerable stress on the growth of defence industries. After the war was aver the production capacities that were created in these industries were not required and the massive employment which was provided in these industries had become redundant. In contrast, the industries which produced consumer goods and machines to be used in consumers goods industries did not have the required capacities. This imbalance could not be corrected immediately. It needed smooth transition otherwise it could create serious unemployment and recessionary problems. The founders of the World Bank thus decided that it would assist member countries in bringing about a smooth transition from their war time economies to peace time economies.

From the above discussion it must have become clear to you that the World Bank's basic objective is to assist member countries in raising resources for the reconstruction and development projects. The priority in raising the resources is to be given to private foreign investment while the World Bank's own resources are to be used only to supplement this flow. The World Bank does not give grants and, however, loans are provided only for non-military projects.

Check Your Progress A

1) State the basic objectives of the World Bank.

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2) State which of the following statements are True and which are False:

i) The World Bank is a sister organisation of the International Monetary Fund.

ii) The World Bank provides finance for military projects.

iii) The World Bank is expected to encourage private foreign resources for the reconstruction of war-devastated economies and development of economically backward economies.

iv) The intention of establishing the World Bank was to replace the flow of private foreign capital by its lendings.

v) The World Bank promotes long-teem balanced growth of international trade.

vi) The World Bank assists developed countries to bring about an easy transition of their peace time economies to war time economies.

vii) The World Bank does not give grants to its member countries.

16.3 FUNCTIONS OF THE WORLD BANK

In the previous section you have learnt about the objectives of the World Bank. You may like to know how they are accomplished. From this point of view it is necessary to know the functions of the World Rank which can be broadly classified under the three heads: i) Lending and guaranteeing private loans: ii) Technical assistance; and iii) Stimulating private investment,

16.3.1 Lending and Guaranteeing Private Loans

The World Bank generally channelises transfer of funds from developed countries to developing countries, though transfer of resources from one developed country to another developed country through the World Bank is also permissible. The World Bank provides loans to the member countries in the following ways:

1) Loans out of the World Rank's own resources
2) Loans out of the World Bank's borrowed resources
3) Loans on the guarantee of the World Bank

1) **Loans out of the World Bank's** own resources: The paid-up capital and retained earnings constitute the World Bank's own resources. Share capital of the World Bank has been allocated to the member countries. The shares subscribed by the governments of the member countries are not transferable. The members have contributed 2 per cent of their subscription in the form of gold or the US dollars, which is available to the World Bank for lending purposes. In addition, members have contributed 18 per cent of their subscription in their own currencies which can be used for lending with the consent of the members whose currencies are to be used for this purpose. The remaining 80 per cent of subscription is not available for lending but can be called for meeting the World Bank's obligations which may arise out of its borrowing or guaranteeing loans.

The World Bank generally provides direction to its members in foreign

currencies. However, in exceptional cases it can grant loans to a member in its own currency (that is, in the currency of the borrowing country). The terms and conditions of loans are decided by the World Bank. The interest rate that it charges on its loans is higher than the one it pays on its borrowings. The margin thus provides it for its earnings.

2) **Loans out of the World Bank's borrowed resources:** The World Bank's own resources are small vis-a-vis the amount of loans it has to give to its member countries. It augments its capability to provide loans to member countries by borrowing from the capital markets of the countries in whose currencies it is generally expected to give loans. The advantage of this arrangement is that whereas the capital surplus countries find an outlet for their excess resources, the capital deficit countries manage to get loans at reasonable interest rates which on their own they may not be able to get.

The World Bank has placed its securities with investors in more than 100 countries, both developed and developing. It sells its securities through direct placement with the government, the central banks and the government agencies and in securities markets where they are offered to investors through commercial banks and certain other financial institutions engaged in this work. The World Bank's borrowings range from 2 to 25 years. A careful study of the World Bank's borrowings reveals that it has followed a policy of diversifying its debt by currency, country, source, maturity and technique of borrowing.

3) **Loans on the guarantee of the World Bank:** The World Bank also aims at inducing private foreign capital to flow to developing countries. For this the World Bank guarantees in whole or in part the loans provided by the private investors for which it charges a guarantee commission from the latter. The Bank's policy of guaranteeing loans has stimulated international flow of piivate capital. In order to safeguard its own interest the World Bank usually asks the govemment of the borrower's country to guarantee the loan before it agrees to give its own guarantee. In case of default in repayment of such loans the World Bank has the option of buying up the loan at its par value. This obviously helps the lender. As far as the borrower is concerned, the World Bank may decide a somewhat more convenient schedule for the repayment of the loan. This naturally helps the borrower. Thus, the World Bank manages to avert its losses arising from the defaults of the borrower and the guarantor.

The World Bank's role in international finance is at best extremely modest. This is evident from the fact that as late as 1987-88 the World Bank's lending commitments amounted to $ 14.8 billion and the disbursements were only $ 11.6 billion. In this year though 112 countries received financial support from the World Bank, 6 countries, viz., India, Mexico, Indonesia, Brazil, Turkey and China secured loan commitments in amounts exceeding $ 1 billion each and together they accounted for 61.9 per cent of the loans approved.

Having realised the insufficiency of its resources to meet the capital needs of the developing countries, the World Bank has undertaken certain measures to expand the opportunities for co-financing. There are three major sources of the co-financing, viz., aid-giving agencies (such as OPEC), export-credit institutions and commercial banks. In the past contribution of official aid-giving agencies in co-financing activities' of the Bank has been quite significant. The World Bank tries to involve export-&edit institutions in co-financing capital intensive projects. In recent years the projects financed by the World Bank are being increasingly co-financed by commercial banks.

16.3.2 Technical Assistance

Another important function of the World Bank is to provide technical assistance to member countries. This is necessary from' the point of view of the effective utilisation of financial aid. Most of the developing countries lack technical capabilities to evaluate feasibility of development projects, They also cannot judiciously determine the priorities of the various projects.

The World Bank therefore provides technical assistance usually at the stage of the preparation of a project to member-countries,

The World Bank conducts surveys in different countries with a view to identify the resource potential of a country as well as the obstacles in its utilisation. It also tries to find out the most appropriate technology for the country given its conditions. These techno-economic surveys and studies on the performance of the member countries help the World Bank and other investors in taking decisions on the requests for loans from the member-countries, The aid recipients also benefits from these studies as it helps them in deciding their policy mix and improving the management of their economic organisations.

The World Bank has also set up an institute to provide training to senior officials of the developing countries in various aspects of economic development. The institute known as the Economic Development Institute conducts training programmes in management of resources, project evaluation, rural development, development of infrastructure, development banking, and so on.

16.3.3 Stimulating Private Foreign Investment

The founders of the World Bank had expected that it would stimulate a direct inter-country flow of capital between private lenders and borrowers. The World Bank reiterated this objective in its Fourth Annual Report. It stated that "over the long run, it is only the sustained flow of private capital that can provide external financial assistance in amounts sufficient to make a significant inroad on the world's development needs." The direct private foreign investment has been considered desirable for two reasons: i) to avoid fixed interest charges, and ii) to obtain essential technical and managerial skills which are available with such investments and generally not obtainable in any other way.

In practice, however, the World Bank has not succeeded much in stimulating a direct international flow of private capital. There are twa main reasons for this failure:

1) To create conditions for self-sustained growth most underdeveloped countries need investments of the kind which are undoubtedly productive in the long run, but are not quick yielding. Such investments, therefore, do not interest private lenders belonging to developed countries.

2) Over the past few decades extensive investment opportunities have existed in potential creditor countries. Hence, private capital has little desire to make investments in developing countries where risks in the form of discrimination, double taxation, transfer problems and even nationalisation are not entirely imaginary.

Check Your Progress B

1) State the three main functions of the World Bank.

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2) In what ways the member countries receive financial assistance from the World Bank or on its guarantee?

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3) State which of the following statements are True and which are False:

i) The World Bank channelises only the transfer of funds from developed countries to developing countries.

ii) The paid up capital and retained earnings of the World Bank constitute its own resources.

iii) The entire amount of the subscribed capital is available to the World Bank for lending purposes.

iv) The World Bank generally provides direct loans to its members in foreign currencies.

v) The World Bank has followed a policy of diversifying its debt.

vi) The World Bank renders a free guarantee service to the borrowers of private loans.

vii) The World Bank does not provide any other service to the member countries except the financial assistance.

viii) The World Bank has greatly succeeded in stimulating private investment.

16.4 OPERATIONS OF THE WORLD BANK

Operations of the World Bank are guided broadly by some general lending principles. However, under special circumstances the World Bank provides loans for structural adjustment in the borrowing countries. These special circumstances loans and the loans to finance a part of the local cost of a project have been a subject of controversy. Therefore, we shall also attempt to examine if there is any rationale for these loans.

16.4.1 General Lending Principles

The World Bank usually follows the following principles while giving direct loans or guaranteeing the private loans so as not to expose its funds to unwarranted risks.

1) The amount of loan or loans which a country may get from the World Bank or from private foreign investors on the guarantee of the Bank is not limited by the recipient country's subscribed capital. However, the World Bank takes into consideration the credit worthiness of the borrower and the guarantor. This is done to ensure that, amongst other things, the borrowing country should be in a position to meet its debt servicing obligations out of its foreign exchange earnings.

2) The World Bank gives loans for non-military productive projects. Under no circumstances loans are given for non-productiye purposes. Though the World Bank claims that while making loan commitments it is guided entirely by economic considerations, its critics accuse it of sanctioning loans often on political considerations.

3) The World Bank gives loans to member governments or on their guarantee to other agencies for particular projects. The loan given for a project cannot be diverted to any other use. This approach has its limitations and the programme lending technique has been designed to meet some of them. Programmes can be made of projects and it is possible for funds provided to fill a calculated foreign exchange or savings gap to be used for specific purposes.

4) The World Bank insists on a written report specifying both the desirability and feasibility of the project for which a loan is sought. After satisfying itself about the financial soundness of the projects, the World Bank sanctions or guarantees a loan. The bank also ensures that besides yielding return that would be enough to meet debt service obligations and generate some surplus, the project concerned would also contribute to the economic growth of the borrowing country.

5) Before agreeing to give a loan to a member country the Bank must ensure that under the prevailing market conditions the borrowing country cannot obtain loans elsewhere on terms and conditions which in its opinion are reasonable for the borrower. The World Bank normally gives a loan only to cover foreign exchange component of the project. Only in special circumstances the World Bank may finance a part of the local cost of the project. Since the World Bank's lendings are normally in foreign exchange, it insists that the repayment of the

loan and the payment of interest earned on it should be in currencies in which the loan was given.

6) The World Bank has a right to determine the amount of loan and decide its terms and conditions. However, the rates of interest and other charges should be reasonable and payment schedules must be appropriate to the proyect. Among the conditions laid down for giving a loan the World Bank cannot include a condition that the loan would be country-tied implying that the amount of loan should be spent in a specific country. In this regard the only valid condition is that the borrowing country spends the amount of loan in the economies of the World Bank's member countries.

16.4.2 Structural Adjustment Loans

In the previous section it has been mentioned that under special circumstances non-profit Ioans and loans to finance a part of the local cost of a project can bc provided by the World Bank. The World Bank has used these provisions stated in the **Articles of Agreement** for giving loans for structural adjustment in the economies of the borrowing countries since 1979-80.

According to the World Bank, the need for structural adjustment loans arose on account of certain serious developments during the late 1970s when most of the developing countries (non-oil exporting) faced serious balance of payments problems. The deficits in their balance of payments rose rapidly due to continuous increase in the prices of imports while their export earnings showed no sign of improvement. The prices of imports had risen on account of repeated oil price hikes and raging inflation in the advanced countries of the west. The situation did not change during the 1980s and for the developing countries the task of improving balance of payments position looked rather difficult under these circumstances. A number of developed countries which had taken loans from the World Bank found it difficult to meet their debt service obligations. Economic inter dependence between the developed and developing countries could adversely affect the former, as it could lead to shrinking of their export markets. Repayment of the loans given by developed countries to less developed countries could be defaulted.

Solution to these problems lay in lowering the protectionist walls and thereby allowing imports from the developing countries. But the western countries did not accept this solution; rather they imposed the burden of adjustment on less developed countries. With their dominant position in the World Bank they influenced the policy of the Bank and a programme in support of their approach was launched. In a nutshell the approach requires that the less developed countries restructure their economies so as to be able to improve their balance of payments position. In this attempt they could not hope for any cooperation from the developed countries. In the broad framework of this approach in 1979-80 the World Bank began a policy of 'structural adjustment lending' which was designed to provide support to those governments which (i) had requested for such support and (ii) had also recognised the need to introduce, as a matter of urgency, a package of measures designed to adjust the structure of productive activities of their economies to the deteriorating balance of payments situation. Such lending is subject to a number of stringent conditions dictated by the World Bank to the borrowing countries. These conditions require major changes in the government policies.

The structural adjustment loans are generally medium term. The World Bank's assertion in favour of structural adjustment loans is that they aim at achieving two important objectives. **First,** such loans support programmes to restructure productive sectors with **a** view to improve the balance of payments position of the borrowing countries. **Second,** these loans act as a catalyst for the inflow of other foreign capital which may improve the balance of payments position.

The World Bank's policy of structural adjustment lending has invited serious criticism in some countries. Critics are not wrong when they assert that the structural adjustment lending of the Bank carries with it a high degree of conditionality which is prejudicial to the interests of the borrowing countries. **Structural adjustment loans are generally a** small **portion of the current account deficits of the balance of payments of the country.** The World Bank while sanctioning structural adjustment

loans insists that the borrowing country adopts a package of pricing policies, liberalisation measures, monetary and fiscal policies and the public investment priorities recommended to it by the Bank. In this policy framework the entire burden of adjustment falls on the less developed countries. In brief, structural adjustment loans have been used by the World Bank to interfere in the economic management of sovereign governments.

16.4.3 Local Currency Expenditures and Other Problems

The operations of the World Bank reveal that there are some practical difficulties in adhering to the lending principles which we have discussed earlier in this section. First, under normal circumstances the World Bank will not finance local investment component of a project. But such a policy would imply inequity in the World Bank's lending. On the one hand, the least developed countries in the world who need the maximum external assistance often even fail to mobilise enough of domestic resources for meeting the local investment expenditure component. The World Bank, therefore, denies them loan for the importation of capital equipment. In contrast, developing countries in the middle income group do not find much difficulty in raising resources for the local investment component of the project. This easily entitles them for loan from the World Bank. Thus, the World Bank's insistence on the exceptional circumstances clause for providing loan in local currency violates the norms of fairness.

A multilateral system is defined as the one where all currencies are convertible and a loan received in any currency can be used for paying for imports from any country. Hence the borrowing country is not obliged to import goods only from the country in whose currency it has received a loan. However, in practice due to lack of convertibility of currencies and absence of multilateralism the countries getting loans from the World Bank has to import goods often from those countries only in whose currencies the loans have been provided. Thus, the second difficulty is that though the World Bank has imposed no condition about spending the loan amount in a particular country, in practice most aid becomes country tied due to the absence of multilateralism.

Finally, a borrowing country sometimes fails to live up to its promises due to acute foreign exchange problem. In this case, the failure of the country may not necessarily be the result of its economy's non-performance. In fact, often a deficit or a surplus in the balance of payments of a country is determined by a number of such factors on which the country may not have any control whatsoever. Under these circumstances the borrowing member may apply to the World Bank for a relaxation of the conditions of repayment. If the World Bank is satisfied that the basis on which a relaxation of the conditions of repayment of loans is justified and the relaxation itself is in the interest of the member, the other members and the World Bank, it can do two things: (i) it can accept service payment in the currency of the borrowing member and advise it to repurchase such currency over time on appropriate terms; and (ii) it can modify the terms and conditions of amortisation or extend the life of loan; or both.

Check Your Progress *C*

1) What are structural adjustment loans?

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2) State which of the following statements are True and which are False:

i) The amount of loan which a country can get from the World Bank is Limited by its subscribed capital.

ii) The World Bank sometimes gives loans for military projects.

iii) In making loan commitments the World Bank is guided by political considerations only

iv) The World Bank loans are generally project-tied and not country-tied.

v) The World Bank generally gives loans to cover only the foreign exchange component of the projects.

vi) Before making commitment for a loan to a member country the World Bank need not ensure that the country could obtain loan from an alternative source on appropriate terms.

vii) Structural adjustment loan carries with it a high degree of conditionality which may be prejudicial to the interests of the borrowers.

viii) Under no circumstances the World Bank is allowed to give local currency loans.

ix) Due to lack of multilateralism most of the loans given by the World Bank in practice become country-tied,

x) It a borrowing country fails to meet its debt service obligations in respect of loans received from the World Bank, it can apply for a relaxation of the terms and conditions of amortization.

16.5 EVALUATION OF THE PERFORMANCE OF THE WORLD BANK

The role of the World Bank as a source of finance and other services, should be considered in the context of the increased importance of international finance in economic development. By and large, it is agreed that it has assisted in arranging transfer of financial resources from capital surplus developed countries to capital deficit developing countries. Moreover, it has rendered other services including technical assistance on a reasonable scale. This is the positive side of the World Bank's activities. The World Bank's performance over the years has been criticised from two angles: (i) that the contribution of the World Bank in terms of resource mobilisation vis-a-vis the needs of the developing countries has been only marginal; and (ii) that the World Bank's policies have been discriminatory and prejudicial to the interests of the developing countries. In this section, we shall examine both the contribution and the failures of the World Bank.

16.5.1 The World Bank's Contribution

In the earlier period of its existence the World Bank had paid greater attention to reconstruction of industrial economies which were devastated by World War II. Having completed this task, **The World Bank directed its attention to the development needs of the relatively underdeveloped countries.** The task of development in economically backward economies is really gigantic and the World Bank's resources from this point of view are meagre. However, within its resources the World Bank has provided loans to countries whose projects, seem economically sound but who cannot get loans from any other source at appropriate rates of interest and other reasonable terms and conditions.

The World Bank's real importance, however, lies not in the loans that it sanctions out of its own resources, but in the bonds that it floats in developed capital markets to accumulate funds for providing loans. In this way **The World Bank has become a major channel whereby the developing counties have acquired an access to the international bond** market and other financial markets. This is of critical importance, particularly for those countries which rely heavily on commercial capita and are sensitive to impact of fluctuations in the world economy.

In order to augment resource transfer from capital surplus developed countries to capital deficit developing countries the Bank has been collaborating with export credit agencies and commercial banks. In response to growing demand for resources from the World Bank and other financial institutions various co-financing instruments have been developed. The World Bank with technical expertise at its disposal has the capability to evaluate investment programmes and individual projects for which aid is sought. It uses this expertise to support the efforts of both

the export-credit agencies and the commercial banks to improve the quality of lending.

Low income economies need finance on concessional terms. The World Bank itself is not able to provide concessional finance in a large quantity. However, if one takes into account the activities of the International Development Association, an affiliate of the World Bank, then the position is not as disappointing as it apparently looks. The International Development Association is often referred to as the "soft loan window" of the World Bank, as it has given loans on easy terms and has not ignored the claims of the low-income economies.

Private foreign investment is an important aspect of the World Bank's catalytic role in international capital flows. In the past, the World Bank together with its affiliate the International Finance Corporation, has attempted to stimulate private foreign investment both directly and indirectly. The system of guaranteeing loans has encouraged direct private foreign investment. The, World Bank's indirect contribution to encouraging the flow of private foreign investment has been in terms of financing investments in physical and human infrastructure in developing countries which in turn has improved the prospects for private investment in these countries.

Finally, **the World Bask has lately played an important role in the area of poverty alleviation.** Earlier the thinking in the World Bank was that the benefits of economic growth would trickle down and thus would reach the poorest of the poor. Therefore, the major emphasis of the World Bank was on financing infrastructural project in the field of power generation and distribution, transportation, ports development, telecommunications, and irrigation. Loans for these projects accounted for about 75 per cent of the total loans sanctioned by the World Bank till 1971-72. Agriculture and rural development until 1971-72 received very little project aid. In his tenure as the President of the World Bank, McNamara made a radical change in the lending policy of the World Bank. Stressing the point that the bottom 40 per cent of the people in less developed countries had not benefited from the economic growth that had taken place during the 1960s, he asserted that the World Bank's lending policy would be guided in future by its relevance for the disadvantaged 40 per cent people of the underdeveloped countries. This required a change in the choice of the projects. Under McNamara's influence agriculture and rural development projects received a high priority. This explains why the World Bank's lending for agriculture rose from 13.3 per cent during the 1960s to 28.4 per cent during the 1970s and 1980s. Samuelson is right when he asserts that McNamara has shifted the World Bank's "focus toward a concern for the very poorest in the developing countries. The best private commercial banks, by their nature, cannot have such a concern for human hunger and disease, for minimum life standards and the mitigation of inequality of opportunity and position."

16.5.2 Failures of the World Bank

In quantitative terms if one attempts to evaluate the performance of the World Bank, then its role in international capital flows has been certainly marginal. During the 1960s the World Bank's loans accounted for a mere 4 per cent of the total international capital flows. Since then there has been no significant change in this share and in no year the World Bank's loans have exceeded 10 per cent of the international capital flows. Hence, the World Bank's role in' international finance should not be exaggerated.

Moreover The World Bank charges a high rate of interest and other charges which reflect its commercial approach. This seems to be inevitable, because the Bank is dominated by developed countries which have no interest in loans on concessional terms to the developing countries.

The World Bank has often been criticised for pursuing policies which are prejudicial to the interests of developing countries. From this point of view the following criticisms deserve particular attention:

First The World Bank generally attempts to tie its loan with a particular project. The project approach can be defended principally on the basis of accountability. However, from the borrowing country's point-of view, it is not the most appropriate

approach. Projects are often inter linked and an attempt to stick strictly to a project in isolation may not always yield the maximum returns. A programme-tied aid is no doubt preferable to a project-tied aid. Programmes can be made up of projects and if the aid is for the programme, then borrower has greater freedom to use aid at the programme implementation level.

Secondly, it is alleged that due to the domination of the USA and other western developed countries The World Bank has become an instrument in the hands of neo-imperialists. The main purpose of encouraging flow of foreign capital from the developed to the developing economies is to acquire a firm control over the less developed countries. This allegation against the World Bank is at least partially true.

Finally, the structural adjustment lending is being done with the objective of influencing the domestic policies of the borrowing countries. The western countries which dominate the World Bank are aware of the fact that economically backward countries facing capital shortages are in a highly vulnerable position. They can be made to accept any conditions when they seek loans from the World Bank. They can, therefore, be advised to follow a policy package tailor-made to serve the interests of the dominant members of the World Bank. This criticism of the World Bank in respect of structural adjustment loans is not entirely false.

Check Your Progress D

1) State which of the following statements are True and which are False:

i) The positive side of the World Bank's activities is that it has encouraged international flow of capital.

ii) Considering the needs of developing countries the World Bank's lending to these countries has been significant.

iii) The World Bank's policies are prejudicial to the interests of developed countries.

iv) The real importance of the World Bank arises from the fact that it has emerged as a channel by which the developing countries have an access to international bond market.

v) Neither the World Bank nor its affiliate IDA gives loans on concessional terms.

vi) The World Bank's distribution of loan purposewise has changed since McNamara became its President.

vii) Alleviation of poverty has always been a criterion for the World Bank's lendings.

viii) A programme-tied aid rather than a project-tied aid is more flexible from the point of view of the borrowing country.

ix) Encouragement of private foreign capital involves the risk of serving the interests of the neo-imperialists,

16.6 LET US SUM UP

Discussion to set up the International Bank for Reconstruction and Development, also known as the World Bank, was taken up at Bretton Woods in 1944. It started functioning in 1946. The main objectives of the World Bank, as stated in the Articles of Agreement, are:

1) To provide finance and technical help for the reconstruction of war devastated economies;

2) To give financial and technical assistance to developing countries for their development projects.

3) To promote international flow of private foreign investment with the hope that capital surplus economies will find an outlet for their excess financial resources while the capital deficit countries will be able to raise their investment level

despite low level of domestic savings.

4) To aim at promoting long term balanced growth of international trade with the hope that it would increase the welfare of the people the world over.

5) To assist member countries in bringing about an easy transformation of their war time economies into peace time economies.

In order to realise these objective; the World Bank performs a number of functions which can be classified broadly under three heads: i) lending and guaranteeing private foreign loans; ii) providing technical assistance; and iii) stimulating private foreign investment. Among these the first one is the most important. The member-countries can get financial assistance from the World Bank in three ways. First, the World Bank lends out of its own resources. Second, the Bank also lends out of resources borrowed from the capital markets of the world. Third, in order to induce international flow of private capital it guarantees loans given by private investors. In addition, it participates in the co-financing with certain aid-giving agencies, export-credit institutions and commercial banks. Technical assistance which is essential from the point of view of the effective utilisation of financial assistance, is also provided by the World Bank.

The lending operations of the World Bank are guided by certain principles. The main principles are: i) Lending to a country is not limited by its subscription but by its debt servicing capacity, ii) Loans are normally project tied and are to be given only for productive purposes on entirely economic considerations. The project must be feasible and necessary from the country's development point of view. iii) The Loan should be granted only when the country seeking financial assistance cannot raise capital on reasonable terms from any other source. iv) The World Bank normally gives loan to cover only foreign exchange component of the project. Hence, its lendings are in foreign exchange and repayment is also expected in the currency in which the loan was given.

Countries with persistent deficits in their balance of payments can get structural adjustment loans from the World Bank to finance projects which will bring about such structural changes in their economies that their balance of payments position improves. However, these loans carry with them stringent terms and conditions. Moreover, the World Bank recommends a package of price, income, money and fiscal policies along with the priorities in respect of productive activities to the country receiving structural adjustment loan. This approach of the World Bank has resulted in its interference in the domestic matters of the borrowing country.

The lending activities of the World Bank involve a number of problems. First, the World Bank's policy of not financing local investment component of a project often results in denial of credit to least developed countries. Second, due to lack of multilateralism the World Bank loans, in practice, have become country-tied. Third, often failure of the borrowing country in meeting debt service obligations eventually results in modifications in the terms and conditions of amortisation and this in turn puts premium on default.

Taking an overall view of the World Bank's performance, it has to be admitted that the World Bank has certainly played an important role in international transfer of financial resources. However, considering the needs of the developing countries the amount of resource transfer through the World Bank is relatively small. Moreover, some of its policies are prejudicial to the interests of the developing countries.

16.7 KEY WORDS

Amortisation: Setting aside money at regular intervals from the point of view of the repayment of debt.

Co-financing: Financing by more than one agencies jointly.

Country-tied Loan: Loan carrying a condition that its amount is to be spent in a particular country.

Debt-servicing: Payment of interest and repayment instalments

Development Projects: Projects aimed at economic development

Foreign Aid:Official external assistance that includes both grants and loans.

Grants: External assistance that carries no repayment obligations

International Investment: Investment involving savings of a foreign country.

Less Developed Economy: An economically backward economy, also now referred to as an under-developed economy or a developing economy.

Local Cost of a Project:Cost of a project that is expected to be met out of the resources domestically mobilised.

Paid-up Capital: That component of the share capital which has been paid by the share holders of the corporate enterprise.

Peace-time Economy: Economy oriented to development rather than war.

Private Foreign Capital:Capital provided by foreign individuals or private institutions.

Project-tied Aid: Financial assistance for a particular project only.

Retained Earnings: Undistributed profits of the corporate enterprise.

Structural Adjustment Loan: Loan with the objective of enabling the borrowing country to make required structural adjustments.

Subscribed Capital: That component of the share capital which has been subscribed by the interested investors.

Technical Assistance:Assistance in respect of technical knowhow.

War-time Economy: Economy oriented to war rather than development.

16.8 ANSWERS TO CHECK YOUR PROGRESS

A) 2) i) True ii) False iii) True iv) False v) True vi) False vii) True

B) 1) i) Lending and guaranteeing private loans
ii) Providing technical assistance
iii) Stimulating private investment

2) i) Loans out of the World Bank's own resources
ii) Loans out of its borrowed resources
iii) Loans on its guarantee

3) i) False ii) True iii) False iv) True
v) True vi) False vii) True viii) False ix) True

C) 2) i) False ii) False iii) False iv) True
v) True vi) False vii) True viii) False ix) True x) True

D) 1) i) True ii) False iii) False iv) True
v) False vi) True vii) False viii) True ix) True

16.9 TERMINAL QUESTIONS

1) What are the objectives of the World Bank?

2) Discuss the functions of the World Bank. Does its performance solve the capital scarcity problems of less developed countries?

3) What is the rationale for structural adjustment loans provided by the World Bank? Why are they being criticised?

4) Critically evaluate the contribution of the World Bank to international capital, flow.

5) What are the failures of the World Bank? Could it perform better if it was not dominated by the developed countries?

Note: These questions will help you to understand the unit **better.** Try to write answers for them. But do not submit your answers to the University for assessment. These are **for** your practice **only.**

SOME USEFUL BOOKS

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