1 BARTER AND EVOLUTION OF MONEY

1. BARTER SYSTEM

Money is something which is generally accepted as a medium of exchange. It is one of the most basic and significant inventions of mankind. Before money came into use, exchange took place through barter system, i.e., goods were exchanged for goods. Barter means direct exchange of goods. In other words, barter refers to exchanging of goods without the use of money. For example, corn may be exchanged for cloth, house for horses, bananas for oranges and so on.

The barter system has certain *advantages* :

(*i*) It is a simple system devoid of the complex problems of the modern monetary system.

(*ii*) There is no question of over or under-production (or of unemployment or over-full employment) under the barter system since goods are produced just to meet the needs of the society.

(*iii*) The problems of international trade, such as, foreign exchange crisis, adverse balance of payments do not exist under barter system.

(*iv*) There is no problem of concentration of economic power into the hands of a few rich persons under the barter system because there is no possibility of storing the commodities.

(*v*) Personal and natural resources are ideally utilised to meet the needs of the society without involving any wastage.

(*vi*) The barter system also reaps the benefits of division of labour because it represents a great step forward from a state of self- sufficiency in which every man has to be a jack of all trades and master of none.

Barter system was in existence in the primitive communities emerging from subsistence economy to exchange economy. In these communities, the economic units were mostly self-sufficient and there was very little trade activities. Even today, in some parts of African countries and even in some backward rural areas of India, barter exchange prevails. Barter system works well in a traditional society in which human wants are basic and a few, the level of economic development is very low, the scale of production is small and the exchange is limited. As the society develops, exchange through barter becomes more and more difficult and the need for money is increasingly felt.

Difficulties of Barter System

Barter system involves various difficulties and inconveniences which are discussed below :

1. Double Coincidence of Wants. Under barter system, a double coincidence of wants is required for exchange. In other words, the wants of the two persons who desire to exchange goods must coincide. For example, if person A wants to acquire shoes in exchange for wheat, then he must find another person who wants wheat for shoes. Such a double coincidence of wants involves great difficulty and wastage of time ; in a modern society, it rarely occurs. In the absence of a double coincidence of wants, the individuals under barter system are compelled either to hold goods for long periods of time, or to make numerous intermediary exchanges in order to get finally the goods of their choice.

2. Absence of Common Measure of Value. Even if it is possible to have the double coincidence of wants, the absence of a common measure of value creates great problem because a lot of time is wasted to strike a bargain. Since there is no common measure in terms of which the value of a commodity can be expressed, the problem arises how much wheat should be exchanged for how many pairs of shoes.

In fact, under the barter system, every good must be expressed in terms of every other good. If, for example, there are 1000 goods in the economy, then, in the absence of monetary unit, every good can be exchanged for the remaining 999 goods. What is true for one good will be true for all other 999 goods. Thus, the number of unique exchange rates or prices in this 1000-goods economy can be found by the formula :

$$R = \frac{[N(N-1)]}{2}$$

where R = number of exchange rates ; N = number of goods to be exchanged.

Using the above example :

$$R = 1000\,\frac{(999)}{2} = 499500$$

This shows that if a person tries to make a transaction, he will be faced with almost one-half million prices. On the other hand, in a modern economy with 1000 goods and one monetary unit of measurement, the number of exchange rates will be R = N – 1 = 1000 – 1 = 999 only. Thus, the use of a monetary unit of accounting (which is absent in barter system) makes the economic life less costly and facilitates trade.

3. Lack of Divisibility. Another difficulty of barter system relates to the fact that all goods cannot be divided and subdivided. In the absence of a common medium of exchange, a problem arises, when a big indivisible commodity is to be exchanged for a smaller commodity. For example, if the price of a horse is equal to 10 shirts, then a person having one shirt cannot exchange it for the horse because it is not possible to divide the horse in small pieces without destroying its utility.

4. The Problem of Storing Wealth. Under a barter system, there is absence of a proper and convenient means of storing wealth or value. (*a*) As opposed to storing of generalised purchasing power (in the form of money) in a monetary economy, the individuals have to store specific purchasing power (in the form of horses, shoes, wheat etc.) under the barter system which may decrease in value in the due course of time due to physical deterioration or a change in tastes. (*b*) It is very expensive to store specific goods for a long time. (*c*) Again the wealth stored in the form of specific goods may create jealousy and enmity among the neighbours or relatives.

5. Difficulty of Deferred Payments. The barter system does not provide a satisfactory unit in terms of which the contracts about the deferred (future) payments are to be written. In an exchange economy, many contracts relate to future activities and future payments. Under barter system, future payments are written in terms of specific goods. It creates many problems.

Chandler has mentioned three such problems[1] :

(*a*) It may create controversy regarding the quality of goods or services to be repaid in future.

(*b*) The two parties may be unable to agree on the specific good to be used for repayment.

(*c*) Both parties run the risk that the goods to be repaid may increase or decrease in value over the period of contract.

6. Problem of Transportation. Another difficulty of barter system is that goods and services cannot be transported conveniently from one place to another. For example, it is not easy and without risk for an individual to take heaps of wheat or herd of cattle to a distant market to exchange them for other goods. With the use of money, the inconveniences or risks of transportation are removed.

The above discussion clearly indicates that the costs of barter are much more than its benefits particularly in a modern society. The barter system may be suitable for the societies in which individuals have limited wants and simple living and, as a result, a small range of goods and services is produced and there is little trade. But in a modern society, with the expansion of volume and variety of production and increase in the frequency of trade, barter is highly inefficient system of exchange. It is because of the various difficulties of the barter system, money was invented and some kind of monetary system was evolved in every society.

1. I.V. Chander. *The Economic of Money and Banking*, p.4.

2. EVOLUTION OF MONEY

Invention of Money

Increasing difficulties and inconveniences of the barter system led to the invention of money. As the society developed, the division of labour and specialisation increased and, as a result, volume of production and trade expanded. In such conditions, the barter system of direct exchange between various commodities created difficulties, such as, the problem of double coincidence of wants, the problem of common measure of value, etc. In order to overcome these difficulties, money was invented. According to Crowther, *"Money is one of the most fundamental of all man's inventions. Every branch of knowledge has its fundamental discovery. In mechanics it is the wheel, in science fire, in politics the vote. Similarly, in Economics, in the whole commercial side of man's social existence, money is the essential invention of which all the rest is based".*[1]

Money was an invention in the sense that *"it needed the conscious reasoning power of man to make the step from simple barter to money-accounting"*.[2] Money was first used as a unit of account or a numeraire in terms of which all other things were to be measured and compared. The introduction of money as a unit of account was a simple but a significant invention. It allowed the process of goods to be expressed in terms of a common unit of account ; made the non-comparable goods comparable ; and extended the scope of division of labour and specialisation. But, even after the introduction of a common unit of account, trading was still a simple exchange of goods for goods. Only the prices were fixed in terms of one standard commodity (e.g., goat).

The use of money as a unit of account did not, however, remove all the difficulties of barter. There is still the difficulty of bringing the two parties together. This difficulty was removed when the money, the unit of account, also became a medium of exchange. Corn was no longer exchanged for meat ; it was sold for money (e.g., goat) and money was sold for meat. The use of money as the medium of exchange saved time and effort and made multilateral trade possible. The third important use in which money was put was to act as a store of value. With the invention of money, nothing except money was needed to be stored because money, being the general purchasing power, could purchase anything at any time. In this way, the three functions, *i.e.*, unit of account, medium of exchange and store of value, performed by a commodity (called money) together constitute the invention of money.

Development of Money

The origin of money is not known because of the non-availability of recorded information ; it is deep-rooted in antiquity. As Lord Keynes has put it, *"Its origins are lost in the mists when the ice was melting, and may well stretch back into the paradisaic intervals in human history of the inter-glacial periods, when the weather was delightful and the mind free to be fertile of new ideas–in the islands of Hesperides of Atlantis or some Eden of Central Asia."*[3] No doubt, the evolution of money has been a secular process and shall continue to remain so, but the development of money in the present form can be historically traced as it has passed through different stages in accordance with the growth of human civilisation.

These stages are discussed below :

1. Animal Money. In primitive agricultural communities, domestic animals were used as money. Cattle were considered the common instrument of exchange. Different things were valued in terms of the number of cattle they can command in exchange. In ancient India, according to *Arth Veda*, Go-Dhan (cow-wealth) was accepted as a form of money. Similarly, upto the 4th century B.C., cow and sheep were officially recognised forms of money to be used for collecting fines and taxes in the Roman State. In Homeric poems (written in probably 9th century B.C.) the prices of commodities were expressed in terms of ox.

2. Commodity Money. In many countries, primitive money took the form of commodity money. A number of commodities like, bows, arrows, animal skins, shells, precious stones, rice, tea, etc., were used as money. The selection of a commodity to serve as money depended upon different factors, like, the location of the community; climate of the region; cultural and economic development of the society etc. For example,

1. G. Crowther ; *An Outline of Money* (1040), p. 16-17.
2. *Ibid,* p.15.
2. J.M. Keynes : a *Treatise on Money,* Vol. 1, p.3.

communities living by the sea shore chose shells, or fish-hooks as money. In the cold regions like, Alaska and Siberia, people adopted animal skins and furs as money. In the tropical regions of Africa, elephant tusks and tiger jaws were used as money.

Animal and commodity money had many serious disadvantages : (*a*) It lacks uniformity and standardisation; all cows and goats are not identical. (*b*) Animals and commodities are an inefficient store of value; there is always a possibility of loss of value over a period of time; moreover, the cost of storing animal and commodity money is very high (*c*) Animals and commodities are not easily transferable because of difficulties of portability. (*d*) There is the problem of indivisibility. (*e*) The supply of animals and commodities may not be easily and quickly changed.

3. Metallic Money. With the growth of society from pastoral to commercial stage, the composition of money also changed from animal and commodity money to metallic money. Gold and silver were the metals mostly used to form metallic money. Due to their scarcity, usefulness and attractiveness, gold and silver were regarded as natural money. The use of metals as money ultimately led to the development of coinage system. According to A.J. Toynbee, the coinage began in Lydia, a Greek City State around 700 B.C. The coinage continued till the 17th century.

Metallic money (uncoined metals and coins) overcame most of the diffculities of animal and commodity money. But, it had its own disadvantages : (*a*) Quick transactions are not possible through coins. (*b*) On account of its weight, large quantites of coins are not easiliy portable. (*c*) Metallic money can be easily lost and stolen. (*d*) Short-weighing and adulteration problems make the transaction costs of uncoined metallic money higher. Every time the quantity and quality of the metal is to be tested.

4. Paper Money. Paper Money formed the next stage in the evolution of money. It was introduced in the 17th and 18th centuries and has now become the most popular form of money. Initially, due to the safety problem of carrying costlier metals, like gold and silver, from one place to another, the merchants used to carry paper receipts against metallic money. With the passage of time, the scarcity of metals led the state authorities to introduce convertible paper currency ; paper money was convertible into metals. In the later stages, however, paper money developed into flat money or inconvertible legal tender ; paper money was not convertible into metals.

Merits. The following are the advantages of paper money :

(*i*) It is economical. Paper is much cheaper than any other metal.
(*ii*) It economises the use of valuable metals, like gold and silver.
(*iii*) There is no depreciation of metals in system of paper money.
(*iv*) It is convenient to carry paper money from one place to the other.
(*v*) It is easy to store large amounts of paper money in a small vault.
(*vi*) It can be easily replaced.
(*vii*) Changes in the supply of money can be easily made in accordance with the requirements of the economy.

Demerits : Paper money also has some disadvantages :

(*i*) There is always the danger of over-issue of currency notes because the changes in money supply can be made at the will of the government. Over-issue of paper currency results in inflationary situation in the country.
(*ii*) Paper money lacks public confidence because mostly it is not backed by metallic reserves.
(*iii*) Paper money is less durable than metallic money.
(*iv*) Paper money is acceptable only with in the domestic economy, and not for making foreign exchange payments.
(*v*) Since the supply of paper money is liable to quick changes, there is lack of stability in its value.
(*vi*) Fluctuations in the value of paper money generates an atmosphere of uncertainty in the economy which, in turn, promotes speculative activities.
(*vii*) Paper money has no intrinsic value of its own. Thus, when paper money is demonetized, its value falls to zero.

To conclude. The merits of paper money are more than its demerits. In reality, in almost every country, paper money is extensively used. Its so called demerits arise mainly due to ineffective management by monetary authority. Proper and effective control of paper money is conducive to economic prosperity in the country.

5. Credit Money. Along with the paper money, credit money or bank money also emerged due to the development of banking institutions and their credit creation activities. Credit money (*i.e.*, cheques issued against demand deposits), in fact, is not money, it only performs the functions of money. Credit money is, therefore, regarded as near-money.

The credit money is becoming more and more popular becuase of the following advantages : (*a*) Bank money is not so liable to loss or theft as other types of money. (*b*) It can be transported very cheaply, no matter how large is the amount of payment and how great is the distance from payer to the payee. (*c*) Cheques can be written for the exact amount a nd there is no need of making change and counting bills and coins. (*d*) When endorsed by the payee, cheques serve as a convenient receipt for payment.

6. Electronic Banking Stage. The U.S. A. and many other developed countries have now entered into an era of electronic banking. Instead of using cash or cheques, people can make deposits and purchases simply by electronic signals. Does this mean that money is no longer being used or that money has become obsolete? The answer is certainly no. Electronic banking does not mean the death of money. It only means that the method of transferring money is changing. Individuals still must decide what amount of money they should hold ? What part of money should be spent immediately and what part should be saved ? How much should be used to purchase an income-yielding asset? In fact, electronic banking is only one step on a long path in the evolution of money. And, if history is any guide, it will not be the last step.

In short, during the long process of evolution, the character of money has undergone a drastic change. In the modern times, coins, paper currency and credit money are the popular forms of money used everywhere. Animal and commodity money due to their drawbacks, have been obsolete and are rarely in existence in the present world. But, in spite of the great progress of the monetary system in the present times, nowhere in the world has the present monetary system become perfect. It has been under evolution since ages, it is still evolving, and shall ever remain so. In other words. the evolution of money has been a secular process and shall continue to be so.

3. CLASSIFICATION OF MONEY

Broadly speaking, three main types of money exist in a modern economy :

(*a*) metallic money,

(*b*) paper money, and

(*c*) credit money. Economists, however, further classify them into many other forms. Important classifications of money are explained below :

(A) Money Proper and Money of Account

Keynes distinguished between money proper and money of account by saying that, *"the money of account is the description or title and money is the thing which answers to the description"*[1].

Money proper or actual money is the money which is in circulation in a country. It is the medium of exchange and means of payment. In India, for example, the Rupee note and the Rupee coin are the actual money because different types of transactions and payments can be made through them.

Money of account is that in which accounts are maintained. Prices of goods and services, general purchasing power, debts, etc. are all expressed in terms of money of account. Normally, the money proper and the money of account are the same. For example, Indian Rupee acts both as the medium of exchange and the money of account. But, sometimes, the two may be different, particularly at a time of economic crises. For example, after the World War I, in Germany, the money proper continued to be the German Mark, but the money of account changed to the American Dollar becuase of its stable value as compared to the depreciating Mark. Similarly, while the Indian Rupee as the money of account has remained the same, the actual Indian Rupee has been experiencing change in its weight, size and content from time to time.

1. J.M. Keynes, *A Treasise an Money*, vol I.p. 3.

(B) Commodity Money and Representative Money

Money proper or actual money is further divided into commodity money and representative money. Commodity money is made of certain metal and its face value is equal to its intrinsic value. It serves not only as a medium of exchange, but also as a store of purchasing power. It is also called full-bodied money becaue its value is materially equivalent to that of its component stuff. The money proper in circulation which is not full-bodied is called representative money. It is a money whose value is materially greater than the value of the stuff of which it is composed. Paper currency notes are an example of representative money. Representative money may be convertible or inconvertible. It is convertible if the issuing authority is under the obligation to convert it into commodity money. It is inconvertible if the issuing authority is under no obligation to convert it into commodity money.

(C) Legal Tender and Optional Money

On the basis of acceptability, money has been classified into legal tender and optional money. Legal tender money is enforced by law. No one can refuse to accept it as a means of payment. Legal tender money may be of two types : limited legal tender and (*b*) unlimited legal tender. Limited legal tender money is accepted as legal tender only upto a certain limit. For example, in India, the small coins of 1,2,5,10 and 25 paise are legal tender only upto a sum of Rs. 25. That means upto Rs. 25 a person cannot refuse a payment through these small coins and beyond Rs. 25 he is free to refuse these coins. Unlimited legal tender is that money which has to be accepted as a medium of payment upto any amount. For example, in India, 50-paise coins, one rupee coin and currency notes of all denominations are unlimited legal tender.

Optional money is that money which may or may not be accepted as a means of payment; it has no legal sanction. Different credit instruments, like, cheques, bank drafts, etc., are the examples of optional money. No one can be forced to accept them.

(D) Metallic Money

The money made of metal is called metallic money. It refers to coins made of certain metals, *e.g.*, gold, silver, copper, nickel, etc. A coin is a piece of metal of a specific size, shape, weight and fineness whose value is certified by the government..

Minting of coins is the monopoly of the State. Metallic money is of two types:

(*a*) standard or full-bodied money and (*b*) **token money.**

1. Standard Money. Any money whose face value (i.e., the exchange value of the coin as fixed by the issuing authority and embossed on it) is equal to its intrinsic value (i.e., the worth of the metallic content of money) is called standard money or full-bodied money. Full-bodied money requires the fulfilment of two conditions : (*a*) money can be shifted from monetary to non- monetary uses without any cost ; and (*b*) the metal can be coined into money without limit and without cost. Standard coins are generally made of gold and silver and the moentary systems using them are called gold standard and silver standard.

Main characteristics of standard money are given below :

(*i*) The face value of standard money is equal to its intrinsic value.

(*ii*) There is free coinage of standard money and the mint is open to the public.

(*iii*) Standard money is unlimited legal tender *i.e.*, all big payments can be made in terms of the standard money to an unlimited extent.

(*iv*) Standard money is the principal money of the country, *i.e.*, it is the medium of exchange and the money of account of the country.

(*v*) The purchasing power-of the standard money may change in terms of other commodities. For example, if the prices of all others goods and services rise, purchasing power of the standard money will fall and vice versa. Thus, the use of standard money does not prevent inflation or deflation.

The standard money has various advantages and disadvantages. Main *advantages* of standard money are: (*a*) Since standard money is full-bodied money, it inspires public confidence. (*b*) Standard money serves as a better means of storing purchasing power. (*c*) Standard money is easily acceptable in foreign payments. (*d*) There is no danger of over-issue of standard money since the metals of which the standard money is made of short supply. The *disadvantages* of the standard money are : (*a*) Standard money is uneconomical because is composed of the most valuable metals and thus involves national wastage. (*b*) The supply of standard money is not elastic, *i.e.*, it cannot be increased according to the demand requirement of the country.

2. Token Money. The money whose face value is more than is intrinsic value is called token money. Token coins are generally made of cheaper metals, like, copper, nickel, etc. and mostly represent lower denominations.

Main *characteristics* of token money are :

(*i*) The face value of token money is more than its intrinisic value.

(*ii*) Token money is minted by the government and there is no free coinage of it.

(*iii*) Token money is limited legal tender, *i.e.*, it can be used for making payments only to a limited extent.

(*iv*) Token money is subsidiary of standard money and is generally used for making payments in smaller transactions.

The main *merits* of token money are : (*a*) It is more economical than the standard money because it does not use valuable metals. (*b*) The supply of token money is more elastic because it can be easily adjusted to its changing demand. On the other hand, token money also suffers from a number of *defects* : (*a*) Token money inspires less public confidence because it is not full-bodies money. (*b*) It is not a desirable means of storing purchasing power. (*c*) There is always a danger of over-issue of token money. (*d*) Token money is accepted only within the boundaries of a country and not in the international payments. (*e*) Token money is used only in smaller transactions.

(E) Paper Money

The money made of paper is called paper money. It consists of currency notes issued by the government or the central bank of a country. In India, one rupee notes are issued by the Ministry of Finance of the Government of India, and all other currency notes of higher denominations are issued by the Reserve Bank of India.

Paper money is of four types :

(*a*) representative paper money, (*b*) convertible paper money,

(*c*) incovertible paper money, and (*d*) fiat money.

1. Representative Paper Money. Representative paper money is fully backed by gold and silver reserves. Under the monetary system of representative money, gold and silver equal to the value of paper currency issued are kept in the reserves by the monetary authority. The main *advantages* of representative paper money are : (*a*) It economises the use of precious metals. These metals are kept in the reserves. (*b*) There is no fear of over-issue of representative money since paper money is fully backed by metallic reserves. (*c*) It inspires public confidence because the public can get the paper money converted into gold as and when needed.

However, the representative paper money has certain *disadvantages*. (*a*) Since gold and silver reserves are to be maintained, these metals cannot be put to other uses. (*b*) Representative paper money system lacks elasticity because under this system money supply cannot be increased unless equivalent amount of metallic reserves are kept. (*c*) It is not suitable for the poor nations which have deficiency of gold and silver.

2. Convertible Paper Money. The paper money which is convertible into standard coins is called convertible paper money. The main *characteristics* of convertible paper money are : (*a*) The individuals can get their paper money converted into cash. (*b*) The paper money is backed by gold and silver reserves. But, on the assumption that all the currency notes are not simultaneously presented by the public for encashment, the value of metallic reserves is less than the value of the notes issued. (*c*) The reserves comprise of (*i*) metallic portion containing gold, silver and standard coins, and (*ii*) fiduciary portion containing approved securities. (*d*) Gene-rally, the public gets gold and silver in exchange for paper money for making foreign payments.

The main *advantages* of the convertible paper money are : (*a*) It economises the use of valuable metals. (*b*) It is flexible becuase money supply can be increased without maintaining cent per cent metallic reserves. (*c*) It inspires public confidence because paper money is convertible into standard coins. (*d*) It facilitates foreign trade because paper money is converted into gold and silver to make foreign payments.

The *disadvantages* of the convertible paper money are : (*a*) Since the paper currency under this system is not cent per cent backed by gold and silver, there is a fear of over-issue of money supply and the resultant danger of inflation. (*b*) The convertible paper money does not inspire as much public confidence as the respresentative paper money.

3. Inconvertible Paper Money. The paper money which is not convertible into standard coins or valuable metals is called inconvertible paper money. Under the system of inconvertible paper money, the monetary authority maintains no metallic reserves against paper currency. It also gives no guarantee to convert the paper currency into gold and silver. The *merits* of inconvertible paper money are as follows : (*a*) Such a paper currency system economises the use of valuable metals. (*b*) It is also elastic in the sense that the monetary authority can change money supply according to the needs of the economy without keeping proportionate metallic reserves. The inconvertible paper money also has the following *demerits*: (*a*) The danger of paper currency. leading to inflation, always exists in this system. (*b*) It inspires less public confidence than a system of representative paper money.

4. Fiat money. Fiat money is only a variety of inconvertible paper money. Fiat money is backed neither by the metallic nor the fiduciary reserves. In otherwords, the monetary authority gives no guarantee to convert fiat money into valuable metals. According to Keynes, ***"Fiat money is Representative (or, Token) Money (i.e., something the intrinsic value of the material substance of which is divorced from its monetary face value) now generally made of paper except in the case of small denominations - which is created and issued by the State, but is not convertible by law into anything other than itself and has no fixed value in terms of an objective standard."***[1] The main *characteristics* of the flat money are : (*a*) It has significiently less intrinsic value than its face value. (*b*) It is not convertible into any valuable asset. (*c*) It is accepted in transactions at face value because it is unlimited legal tender.

Initially, fiat money was used during the period of war or emergency. But, now, it has become a common phenomenon in most of the countries of the world. Fiat money is particu- laraly useful for underdeveloped countries which generally lack financial resources for economic development. Fiat money removes this deficiency and promotes economic development by providing sufficient resources to the government. However, fiat money also has certain demerits : (*a*) The danger of over-issue of fiat money (or inflation) is always present in a system of fiat money. (*b*) It lacks public confidence as it is not backed by metallic reserves. (*c*) Foreign exchange rates are liable to wide fluctuations under fiat money system because fiat money is not linked with other country's money through gold.

(F) Credit Money

In modem economics, with the development of banking activity, credit money is being widely used. Demand deposits of banks, which are withdrawable through cheques, serve as money and the cheques are accepted as a means of payments. It is to be noted that a cheque by itself is not money ; it is only a credil instrument which performs the functions of money. That is why credit money is regarded as near money.

In a modern economy, currency money (paper money and coins) and bank money constitute the major portion of money supply. As the economy becomes more and more advanced, the proportion of bank money in the total money supply increases. The currency money is a legal tender and is generally accepted. While bank deposits are conventional money and lack general acceptability.

4. MONEY AND NEAR-MONEY

Money consists of (*a*) legal tender money *i.e.*, coins and currency notes and (*b*) bank money (*i.e.*, demand deposits). Money is the perfect liquid asset and can be directly used for making purchases of goods and services. But, the coins and currency are used only for small transactions. In case of big transactions where large payments are involved (for example, purchasing a car or a house), bank money in the form of bank cheques or bank drafts is used. In modern monetary economies, people mostly use bank money in their transactions and thus bank money forms a major proportion of money supply. In this way, bank money is considered as liquid as the legal tender money.

There are other assets also which cannot be technically regarded as money, but are claims to money and perform some functions of money. Such assets are called near-money. Near-money refers to all those assets which possess many of the characteristics of money, have high degree of liquidity and can inexpensively be

1. J.M. Keynes, *A Treatise on Volume* I.p.7.

of money includes (*a*) legal tender money (*b*) bank money and (*c*) near-money, i.e., all those financial assets which can be easily and inexpensively converted into money proper within a short period of time.

2. Increase in Velocity of Money. Near-money influences the velocity of money. A person's ability to spend depends not only on the amount of money he has with him and he holds in the bank (i.e., legal money and bank money), but also on his ability to raise additional funds by selling his near-money assets. In the words of Radcliffe Committee Report, "spending is not limited by the amount of money in existence, but it is related to the amount of money people think they can get hold of whether by receipt of income (for instance from sales), by disposal of capital assets or by borrowing". Thus, the existence of near-money increases the velocity of money (V) and hence aggregate demand (MV) in the economy by activating idle demand deposits and currency.

3. Policy Implications. Near-money has important policy implications for the monetary authorities. The prevalence of near-money assets significantly increases the overall level of liquidity and hence the level of aggregate expenditure. The monetary authority which aims at influencing the level of aggregate expenditure by controlling the money supply alone will fail to achieve its objective. For the monetary policy to be effective, it must influence not only the total stock of money in the economy, but also the total stock of near-money assets. In other words. it must influence not the money supply alone, but the overall level of liquidity. Since the central bank does not have much control over the lending activities of nonbank financial institutions, the growth of near-money assets may create problems in the effective implementation of the monetary policy.

5. QUALITIES OF GOOD MONEY MATERIAL

To be able to perform the functions of money well, the money material must possess the following qualities:

1. General Acceptability. The material of which money is made should be acceptable to all without any hesitation. In this connection, gold and silver are considered as good money material because they are readily acceptable to the general public. Apart from being used as money, these metals can also be put to other uses (*e.g.*, making ornaments.)

2. Portability. Money should be easily carried or transferred from one place to another. In other words, the money material must have large value in small bulk. On this ground, various animals cannot be used as money.

3. Durability. Money material must last for a long time without losing its value. Ice and fruits cannot become good money becuase they lose their value with the passage of time. Ice melts and fruits perish.

4. Divisibility. Money material must be easily sub-divided to allow for the purchase of smaller units of the commodities. Cows, for example, cannot function as good money because a cow cannot be divided without losing its value ; a fraction of cow is quite different entity than a whole cow.

5. Homogeneity. Money should be homogeneous. Its units should be identical ; they should be of equal quality and physically indistinguishable. If money is not homogeneous, the individuals will not be certain of what they are receiving when they make transactions.

6. Cognisability. Money should be easily recognised. If it is not easily recognisable, it would be difficult for the individuals to determine whether they are dealing with money or some inferior asset.

7. Stability. The value of money should remain stable and should not change for a long period of time. If the value of money is not stable, it will not be able to function as a measure of value, as a store of value and as a standard of deferred payment.

8. Malleability. The money material should be capable of being melted and put to different forms. Gold, silver, copper, etc., have this quality.

The precious metals, gold and silver by and large, possess the above mentioned qualities of good money material. It is because of this reason, that these metals have been used as money for a considerably long period of time. Now the notion of money has changed. The modern governments go through trial and error procedures before adopting a common medium of exchange. The main considerations for selecting a money material are general acceptability and cost of producing money. That commodity is chosen to serve as money which will be widely used by the people and which offers the least costly benefits of a common medium of exchange.

(*iii*) Certain problems relating to the concept of liquidity creates further difficulties in adopting the liquidity approach : (*a*) It is not easy to quantify the liquidity content of an asset. (*b*) Liquidity contents of an asset may not be constant.

(*iv*) Since the central bank does not have much control over the lending activities of the non-bank financial institutions, the existence and growth of near-money assets may create problems in the effective implementation of the monetary policy.

Best Definition of Money

The actual experience has shown that both the transactions as well as liquidity approaches are adopted for measuring money supply in an economy. There are not one but many official definitions of money, such as M_1, M_2, M_3, etc. This indicates a movement from narrow medium-of-exchange measure to broad liquidity measures. The broader measures include less liquid assets. The question arises : which is the best definition of money supply ? There is no clear answer to this question. It all depends upon the purpose in hand. For example, if one wants to know which definition of money supply is the most controllable by the monetary authority, the answer is the narrow medium-of- exchange definition. On the other hand, if one wants to know the definition which correlates best with the economic activity, the answer is the broader liquidity definition.

3. FUNCTIONS OF MONEY

Various functions of money can be classified into three broad groups : (*a*) *Primary functions* which include the medium of exchange and the measure of value ; (*b*) *Secondary functions* which include standard of deferred payments, store of value and transfer of value; and (*c*) *Contingent functions* which include distribution of national income, maximisation of satisfaction, basis of credit system, etc.

These functions have been explained below :

1. Medium of Exchange. The most important function of money is to serve as a medium of exchange or as a means of payment. To be a successful medium of exchange, money must be commonly accepted by people in exchange for goods and services. While functioning as a medium of exchange, money benefits the society in a number of ways : (*a*) It overcomes the inconvenience of barter system (i.e., the need for double coincidence of wants) by splitting the act of barter into two acts of exchange, *i.e.*, sales and purchases through money. (*b*) It promotes transactional efficiency in exchange by facilitating the multiple exchange of goods and services with minimum effort and time. (*c*) It promotes allocation efficiency by facilitating specialisation in production and trade. (*d*) It allows freedom of choice in the sense that a person can use his money to buy the things he wants most, from the people who offer the best bargain and at a time he considers the most advantageous.

2. Measure of Value. Money serves as a common measure of value in terms of which the value of all goods and services is measured and expressed. By acting as a common denominator or numeraire, money has provided a language of economic communication. It has made transactions easy and simplified the problem of measuring and comparing the prices of goods and services in the market. Prices are but values expressed in terms of money.

Money also acts as a unit of account. As a unit of account, it helps in developing an efficient accounting system because the values of a variety of goods and services which are physically measured in different units (e.g, quintals, metres, litres, etc.) can be added up. This makes possible the comparisons of various kinds, both over time and across regions. It provides a basis for keeping accounts, estimating national income, cost of a project, sale proceeds, profit and loss of a firm, etc.

To be satisfactory measure of value, the monetary units must be invariable. In other words, it must maintain a stable value. A fluctuating monetaty unit creates a number of socio-economic problems. Normally, the value of money, *i.e.*, its purchasing power, does not remain constant ; it rises during periods of falling prices and falls during periods of rising prices.

3. Standard of Deferred Payments. When money is generally accepted as a medium of exchange and a unit of value, it naturally becomes the unit in terms of which deferred or future payments are stated. Thus, money not only helps current transactions though functions as a medium of exchange, but facilitates credit transaction (i.e., exchanging present goods on credit) through its function as a standared of deferred payments.

But, to become a satisfactory standard of deferred payments, money must maintain a constant value through time ; if its value increases through time (i.e., during the period of falling price level), it will benefit the creditors at the cost of debtors ; if its value falls (i.e., during the period of rising price level), it will benefit the debtors at the cost of creditors.

4. Store of Value. Money, being a unit of value and a generally acceptable means of payment, provides a liquid store of value because it is so easy to spend and so easy to store. By acting as a store of value, money provides security to the individuals to meet unpredictable emergencies and to pay debts that are fixed in terms of money. It also provides assurance that attractive future buying opportunities can be exploited. Money as a liquid store of value facilitates its possessor to purchase any other asset at any time. It was Keynes who first fully realised the liquid store value of money function and regarded money as a link between the present and the future. This, however, does not mean that money is the most satisfactory liquid store of value. To become a satisfactory store of value, money must have a stable value.

5. Transfer of Value. Money also functions as a means of transferring value. Through money, value can be easily and quickly transferred from one place to another because money is acceptable everywhere and to all. For example, it is much easier to transfer one lakh rupees through bank draft from person A in Amritsar to person B in Bombay than remitting the same value in commodity terms, say wheat.

6. Distribution of National Income. Money facilitates the division of national income between people. Total output of the country is jointly produced by a number of people as workers, land owners, capitalists, and entrepreneurs, and, in turn, will have to be distributed among them. Money helps in the distribution of national product through the system of wage, rent, interest and profit.

7. Maximisation of Satisfaction. Money helps consumers and producers to maximise their benefits. A consumer maximises his satisfaction by equating the prices of each commodity (expressed in terms of money) with its marginal utility. Similarly, a producer maximises his profit by equating the marginal productivity of a factor unit to its price.

8. Basis of Credit System. Credit plays an important role in the modern economic system and money constitutes the basis of credit. People deposit their money (saving) in the banks and on the basis of these deposits, the banks create credit.

9. Liquidity to Wealth. Money imparts liquidity to various forms of wealth. When a person holds wealth in the form of money, he makes it liquid. In fact, all forms of wealth (e.g., land, machinery, stocks, stores, etc.) can be converted into money.

In short, the main functions of money can be summed up in the following form :

Money is a matter of functions four,
A medium, a measure, a standard, a store,
As this does not complete the picture,
We may add transferability more.

Static and Dynamic Functions

Paul Einzing has classified the functions of money into two broad categories, i.e., static and dynamic functions :

1. Static Functions. In the static functions, money acts as a passive or technical tool to ensure a smooth working of the economic system. It does not have a causative influence on the economic activities. The traditional functions of money, *i.e.*, medium of exchange, measure of value, standard of deferred payments and store of value, all are the static or technical functions of money. Paul Einzing adds one more technical function, i.e., money as a medium of price mechanism. Prices are the value of goods and services, expressed in money terms. Money is a medium through which the price mechanism operates in order to establish a balance between demand and supply in the market, and, thereby, to reconcile the interests of the producers and consumers.

2. Dynamic Functions. The dynamic functions are those by which money actively influences the economic system through its impact on price level, interest rates, volume of production, distribution of wealth and income etc. In its dynamic role, money tends to influence the economic trends.

1 COMMERCIAL BANKING

1. ORIGIN AND GROWTH OF BANKING

The origin of commercial banking can be traceable in the early times of human history. In the ancient Rome and Greece, the practice of storing precious metals and coins at safe places and loaning out money for public and private purposes on interest was prevalent. In England, banking had its origin with the London goldsmiths who in the 17th century began to accept deposits from merchants and others for safe-keeping of money and other valuables. As public enterprise, banking made its first appearance in Italy in 1157 when the Bank of Venice was founded.

According to Crowther, modern banking has three ancestors : (1) the merchant, (2) the goldsmith, or goldsmith note and (3) the money-lender.

1. The Merchant. Trading activities require remittances of money from one place to another and this is one of the important functions of a bank. Because of the possibility of theft of metallic money during transportation, the traders, with high and widespread reputation or credit, began to issue documents which were taken as titles of money. This gave rise to the institution of 'hundi' or the letter of transfer whereby the banker directs another banker to pay the bearer of hundi the specified amount of money and debit this amount against the drawer of hundi. Modern banks remit money to other places through cheques, drafts, or travelers' cheques. Thus, merchant banker forms the earliest stage in the evolution of modem banking. In the words of **Crowther,** ***"To this day the title 'merchant bankers' is reserved by usage to the older, cosmopolitan and more exclusive private banking firms, nearly every one of which can trace its ancestry back to a trader in commodities more tangible (though hardly more profitable) than money."***[1]

2. The Goldsmith. The gold smith ancestry of the modem banks is purely an English affair. Since goldsmiths dealt with precious metals, they necessarily provided secure safe to protect them. In a period when money consisted of gold and silver, people, largely because of the danger of theft, started leaving their precious bullion and coins in the custody of goldsmiths. As the practice of safe-guarding others' money became widespread the goldsmiths began imposing charges for the safe-keeping service.

3. Goldsmith Notes. The next stage in the development of banking came when the receipt for deposits with the goldsmiths began to be used as a means of payment. People started keeping gold, silver and coins with goldsmiths in exchange for warehouse receipts or goldsmith notes (*i.e.*, claims against the deposits). These warehouse receipts became a medium of exchange and a means of payment.

4. The Money Lender. The next stage in the development of banking arises when the goldsmith becomes a money-lender. This development was based on the goldsmiths' discovery that it was not necessary to hold hundred per cent of the coins deposited with them. The goldsmiths soon realised that, on average, daily withdrawals were equal to daily deposits and only a contingency reserve was required for the periods when withdrawals exceeded deposits. After keeping the contingency reserve, the goldsmiths loaned out the remaining deposits on interest. In this way, the system of fractional reserve banking was born. Thus, goldsmith became a banker; he started performing the two major functions of a bank, *i.e.*, receiving deposits and advancing loans.

2. MEANING AND FUNCTIONS OF BANK

Meaning of Bank

A bank is an institution which deals with money and credit. It accepts deposits from the public, makes the funds available to those who need them, and helps in the remittance of money from one place to another.

1. G. Crowther. : *An Outline of Money*, 1958, pp. 22-23.

In fact, a modern bank performs such a variety of functions that it is difficult to give a precise and general definition of it. It is because of this reason that different economists give different definitions of the bank.

According to **Crowther**, a bank *"collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who require it."* In the words of **Kinley**, *"A bank is an establishment which makes to individuals such advances of money as may be required and safely made, and to which individuals entrust money when not required by them for use."* According to **John Paget**, *"No body can be a banker who does not (i) take deposit accounts, (ii) take current accounts, (iii) issue and pay cheques, and (iv) collects cheques-crossed and uncrossed-for its customers."*

Prof. Sayers defines the terms bank and banking distinctly. He defines a bank as *"an institution whose debts (bank deposits) are widely accepted in settlement of other people's debts to each other."* Again, according to Syaers, *"Ordinary banking business consists cash for bank deposits and bank deposists for cash ; transferring bank deposits from one person or corporation to another ; giving bank deposits in exchange for bills of exchange, government bonds, the secured promises of businessmen to repay and so forth".* According to the Indian Companies Act, 1949, banking means *"the accepting for the purpose of Indian Companies lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft or otherwise."*

In short, the term bank in the modern times refers to an institution having the following features:

(*i*) It deals with money ; it accepts deposits and advances loans.

(*ii*) It also deals with credit ; it has the ability to create credit. *i.e.*, the ability to expand its liabilities as a multiple of its reserves.

(*iii*) It is commercial institution ; it aims at earning profit.

(*iv*) It is a unique financial institution that creates demand deposits which serve as a medium of exchange and, as a result, the banks manage the payment system of the country.

Functions of Commercial Banks or Modern Banks

In the modern world, banks perform such a variety of functions that it is not possible to make an all-inclusive list of their functions and services.

However, some basic functions performed by the banks are discussed below :

1. Accepting Deposits. The first important function of a bank is to accept deposits from those who can save but cannot profitably utilise this saving themselves. People consider it more rational to deposit their savings in a bank because by doing so they, on the one hand, earn interest, and on the other, avoid the danger of theft.

To attract savings from all sorts of individuals, the banks maintain different types of accounts :

(*i*) **Fixed Deposit Account.** Money in these accounts is deposited for fixed period of time (say one, two, or five years) and cannot be withdrawn before the expiry of that period. The rate of interest on this account is higher than that on other types of deposits. The longer the period, the higher will be the rate of interest. Fixed deposits are also called time deposits or time liabilities.

(*ii*) **Current Deposit Account.** These accounts are generally maintained by the traders and businessmen who have to make a number of payments every day. Money from these accounts can be withdrawn in as many times and in as much amount as desired by the depositors. Normally, no interest is paid on these accounts. Rather, the depositors have to pay certain incidental charges to the bank for the services rendered by it. Current deposits are also called demand deposits or demand liabilities.

(*iii*) **Saving Deposit Account.** The aim of these accounts is to encourage and mobilise small savings of the public. Certain restrictions are imposed on the depositors regarding the number of withdrawals and the amount to be with drawn in a given period. Cheque facility is provided to the depositors. Rate of interest paid on these deposits is low as compared to that on fixed deposits.

(*iv*) **Recurring Deposit Account.** The purpose of these accounts is to encourage regular savings by the public. particularly by the fixed income group. Generally money in these accounts is deposited in monthly instalments for a fixed period and is repaid to the depositors along with interest on maturity. The rate of interest on these deposits is nearly the same as on fixed deposits.

(v) **Home Safe Account.** Home safe account is another scheme aiming at promoting saving habits among the people. Under this scheme a safe is supplied to the depositor to keep it at home and to put his small savings in it. Periodically, the safe is taken to the bank where the amount of safe is credited to his account.

2. Advancing of loans. The second important function of a bank is advancing of loans to the public. After keeping certain cash reserves, the banks lend their deposits to the needy borrowers. Before advancing loans, the banks satisfy themselves about the creditworthness of the borrowers.

Various types of loans granted by the banks are discussed below:

(*i*) **Money at Call.** Such loans are very short period loans and can be called back by the bank at a very short notice of say one day to fourteen days. These loans are generally made to other banks or financial institutions.

(*ii*) **Cash Credit.** It is a type of loan which is given to the borrower against his current assets, such as shares, stocks, bonds, etc. Such loans are not based on personal security. The bank opens the account in the name of the borrowers and allows him to withdraw borrowed money from time to time upto a certain limit as determined by the value of his current assets. Interest is charged only on the amount actually withdrawn from the account.

(*iii*) **Overdraft.** Sometimes, the bank provides overdraft facilities to its customers though which they are allowed to withdraw more than their deposits. Interest is charged from the customers on the overdrawn amount.

(*iv*) **Discounting of Bills of Exchange.** This is another popular type of lending by the modern banks. Through this method, a holder of a bill of exchange can get it discounted by the bank. In a bill of exchange the debtor accepts the bill drawn upon him by the creditor (*i.e*, holder of the bill) and agrees to pay the amount mentioned on maturity. After making some marginal deductions (in the form of commission), the bank pays the value of the bill to the holder. When the bill of exchange matures, the bank gets its payment from the party which had accepted the bill. Thus, such a loan is self-liquidating.

(*v*) **Term Loans.** The banks have also started advancing medium-term and long-term loans. The maturity period for such loans is more than one year. The amount sanctioned is either paid or credited to the account of the borrower. The interest is charged on the entire amount of the loan and the loan is repaid either on maturity or in instalments.

3. Credit Creation. A unique function of the bank is to create credit. In fact, credit creation is the natural outcome of the process of advancing loan as adopted by the banks. When a bank advances a loan to its customer, it does not lend cash but opens an account in the borrower's name and credits the amount of loan to this account. Thus, whenever a bank grants a loan, it creates an equal amount of bank deposit. Creation of such deposits is called credit creation which results in a net increase in the money stock of the economy. Banks have the ability to create credit many times more than their deposits and this ability of multiple credit creation depends upon the cash-reserve ratio of the banks.

4. Promoting Cheque System. Banks also render a very useful medium of exchange in the form of cheques. Through a cheque, the depositor directs the bankers to make payment to the payee. Cheque is the most developed credit instrument in the money market. In the modern business transactions, cheques have become much more convenient method of settling debts than the use of cash.

5. Agency Functions. Banks also perform certain agency functions for and on behalf of their customers :

(*i*) **Remittance of Funds.** Banks help their customers in transferring funds from one place to another through cheques, drafts, etc.

(*ii*) **Collection and Payment of Credit Instruments.** Banks collect and pay various credit instruments like cheques, bills of exchange, promissory notes, etc.

(*iii*) **Execution of Standing Orders.** Banks execute the standing instructions of their customers for making various periodic payments. They pay subscriptions, rents, insurance premia, etc. on behalf of their customers.

(*iv*) **Purchasing and Sale of Securities.** Banks undertake purchase and sale of various securities like shares, stocks, bonds, debentures etc. on behalf of their customers. Banks neither give any advice to their customers regarding these investments nor levy any charge on them for their service, but simply perform the function of a broker.

(v) **Collection of Dividends on Shares.** Banks collect dividends, interest on shares and debentures of their customers.

(vi) **Income Tax Consultancy.** Banks may also employ income-tax experts to prepare income-tax returns for their customers and to help them to get refund of income-tax.

(vii) **Acting as Trustee and Executor.** Banks preserve the wills of their customers and execute them after their death.

(viii) **Acting as Representative and Correspondent.** Sometimes the banks act as representatives and correspondents of their customers. They get passports, traveller's tickets, book vehicles, plots for their customers and receive letters on their behalf.

6. General Utility Function. In addition to agency services, the modern banks provide many general utility services as given below:

(i) **Locker Facility.** Banks provide locker facility to their customers. The customers can keep their valuables and important documents in these lockers for safe custody.

(ii) **Traveller's Cheques.** Banks issue traveller's cheques to help their customers to travel without the fear of theft or loss of money. With this facility, the customers need not take the risk of carrying cash with them during their travels.

(iii) **Letter of Credit.** Letters of credit are issued by the banks to their customers certifying their creditworthiness. Letters of credit are very useful in foreign trade.

(iv) **Collection of Statistics.** Banks collect statistics giving important information relating to industry, trade and commerce, money and banking. They also publish journals and bulletins containing research articles on economic and financial matters.

(v) **Underwriting Securities.** Banks underwrite the securities issued by the government, public or private bodies. Because of its full faith in banks, the public will not hesitate in buying securities carrying the signatures of a bank.

(vi) **Gift Cheques.** Some banks issue cheques of various denominations (say of Rs.11, 21, 31, 51.101, etc.) to be used on auspicious occasions.

(vii) **Acting as Referee.** Banks may be referred for seeking information regarding the financial position, business reputation and respectability of their customers.

(viii) **Foreign Exchange Business.** Banks also deal in the business of foreign currencies. Again, they may finance foreign trade by discounting foreign bills of exchange.

3. ROLE OF COMMERCIAL BANKS IN A DEVELOPING ECONOMY

A well-developed banking system is a necessary pre-condition for economic development in a modern economy. Besides providing financial resources for the growth of industrialisation, banks can also influence the direction in which these resources are to be utilized. In the underdeveloped and developing countries, not only the banking facilities are limited to a few developed urban areas, but also the banking activities are limited mostly to trade and commerce, paying little attention to industry and agriculture. Structural as well as functional reforms in the banking system are needed to enable the banks perform developmental role in underdeveloped countries.

Banks and Economic Development

In a modern economy, banks are to be considered not merely as dealers in money but also the leaders in development. They are not only the store houses of the country's wealth but also are the reservoirs of resources necessary for economic development. Banks play an important role in the development of a country. It is the growth of commercial banking in the 18th and 19th centuries that facilitated the occurrence of industrial revolution in Europe. Similarly, the economic progress in the present day developing economies largely depends upon the growth of sound banking system in these economies.

economic development in these economies requires the development of agriculture and small-scale industries in rural areas. So far, banks, in underdeveloped countries have been paying more attention to trade and commerce and have almost neglected agriculture and industry. Thus, necessary structural and functional reforms in the banking system of the underdeveloped countries should be made in order to encourage the banks to play developmental role in these economies. The banks must diversify their activities not only to extend credit to trade, but also to provide medium-term and long-term loans to industry and agriculture.

Sound Banking System for Underdeveloped Countries

A sound and efficient banking system which undertakes the responsibility of promoting economic growth in underdeveloped economies must possess the following features :

(*i*) The system of branch banking is most suitable for the underdeveloped countries. More and more branches should be opened in rural and backward areas to encourage saving as well as banking habits in these areas.

(*ii*) The system of unit banking may be developed in the limited area, particularly in bigger cities to meet the local financial requirements of trade and industries. This will, on the one hand, reduce pressure on big banks and, on the other hand, check concentration of financial power in the hands of a few banks.

(*iii*) The banking system in the less-developed countries must aim at encouraging capital formation by increasing the rates of savings and investment in these economics.

(*iv*) The banking system in the underdeveloped countries should provide easy and cheap remittance facilities to enable the movement of fund from one place to another so as to promote trade and industry.

(*v*) The loan policy of banks in the underdeveloped countries should be rationalised in such a way that loans for productive purposes should be encouraged and loans for conspicuous consumption and for speculative activities should be discouraged.

(*vi*) The loan policy in underdeveloped countries should also not be restricted to short-term loans alone. The banks should also provide medium-term and long-term loans to developmental activities in these countries.

(*vii*) The banks should meet the different and changing needs of the underdeveloped countries. Credit facilities should be extended to the priority sectors, like agriculture and small scale industries.

(*viii*) Efficient functioning of the banks will inspire public confidence in the banking system and popularise banking activities. This requires trained and efficient banking staff.

In short, comprehensive structural and functional changes in the banking system of the underdeveloped countries are needed. Only after these changes, the banks can be expected to play a proper role in promoting economic development in these countries.

4. TYPES OF BANKS

Banks can be classified into various types on the basis of their functions, ownership, domicile, etc. The following are the various types of banks :

1. Commercial Banks. The banks which perform all kinds of banking business and generally finance trade and commerce are called commercial banks. Since their deposits are for a short period, these banks normally advance short-term loans to the businessmen and traders and avoid medium-term and long-term lending . However, recently, the commercial banks have also extended their areas of operation to medium-term and long-term finance. Majority of the commercial banks are in the public sector. But, there are certain private sector banks operating as joint stock companies. Hence, the commercial banks are also called joint stock banks.

2. Industrial Banks. Industrial banks, also known as investment banks, mainly meet the medium-term and long-term financial needs of the industries. Such long-term needs cannot be met by the commercial banks which generally deal with short-term lending. The main functions of the industrial banks are : (*a*) They accept long-term deposits. (*b*) They grant long-term loans to the industrialists to enable them to purchase land, construct factory building, purchase heavy machinery. etc. (*c*) They help selling or even underwrite the debentures and shares of industrial firms. (*d*) They can also provide information regarding the general economic position of the economy. In India, industrial banks, like Industrial Development Bank of India, Industrial Finance Corporation of India, State Finance Corporations, are playing significant role in the industrial development of the country.

3. Agricultural Banks. Agricultural credit needs are different from those of industry and trade. Industrial and commercial banks normally do not deal with agricultural finance. The agriculturists require (*a*) short-term credit to buy seeds, fertilizers and other inputs, and (*b*) long-term credit to purchase land, to make permanent improvements on land, to purchase agricultural machinery and equipment, etc. In India, agricultural finance is generally provided by co-operative institutions. Agricultural co-operatives provide short-term loans and Land Development Banks provide the long term credit to the agriculturists.

4. Exchange Banks. Exchange banks deal in foreign exchange and specialise in financing foreign trade. They facilitate international payments through the sale and purchase of bills of exchange and thus play an important role in promoting foreign trade.

5. Saving Banks. The main purpose of saving banks is to promote saving habits among he general public and mobilise their small savings. In India, postal saving banks do this job. They open accounts and issue postal cash certificates.

6. Central Bank. Central bank is the apex institution which controls, regulates and supervises the monetary and credit system of the country. Important functions of the central bank are : (*a*) It has the monopoly of note issue ; (*b*) It acts as the banker, agent and financial adviser to the state ; (*c*) It is the custodian of member banks' reserves ; (*d*) It is the custodian of nation's reserves of international currency; (*e*) It serves as the lender of the last resort ; (*f*) It functions as the bank of central clearance, settlement and transfer ; and (*g*) It acts as the controller of credit. Besides these functions, India's central bank, *i.e.*, the Reserve Bank of India, also performs many developmental functions to promote economic development in the country.

7. Classification on the Basis of Ownership. On the basis of ownership, banks can be classified into three categories : (*a*) *Public Sector Banks* : These are owned and controlled by the government. In India, the nationalized banks and the regional rural banks come under these categories. (*b*) *Private Sector Banks* : These banks are owned by the private individuals or corporations and not by the government or co-operative societies. (*c*) *Cooperative Banks* : Cooperative banks are operated on the cooperative lines. In India, cooperative credit institutions are organised under the cooperative societies law and play an important role in meeting financial needs in the rural areas.

8. Classification on the Basis of Domicile. On the basis of domicile, the banks are divided into two categories : (*a*) *Domestic Banks* : These are registered and incorporated within the country. (*b*) *Foreign Banks* : These are foreign in origin and have their head offices in the country of origin.

9. Scheduled and Non-Scheduled Banks. In India, banks have been broadly classified into scheduled and non-scheduled banks. A Scheduled Bank is that which has been included in the Second Schedule of the Reserve Bank of India Act,1934 and fulfills the three conditions (*a*) It has paid-up capital and reserves of at least Rs. 5 lakhs. (*b*) It ensures the Reserve Bank that its operations are not determental to the interest of the depositors. (*c*) It is a corporation or a cooperative society and not a partnership or a single owner firm. The banks which are not included in the Second Schedule of the Reserve Bank of India Act are non-scheduled banks.

5. BANKING SYSTEMS

Different countries adopt different banking systems. Various types of banking systems are :

(*a*) branch banking, (*b*) unit banking,

(*c*) group banking, and (*d*) chain banking.

Branch Banking and Unit Banking

On the basis of organisation and scale of operations, banking systems can be divided into two categories : branch banking system and unit banking system.

1. Branch Banking System. Under branch banking system, a big bank as a single institution and under single ownership operates through a network of branches spread all over the country. To start with,

2 CENTRAL BANKING

1. INTRODUCTION

Meaning of Central Bank

Central bank is the supreme monetary institution which is at the apex of the monetary and banking structure of a country. It is the leader of money market and as such controls, regulates and supervises the activities of commercial banks. It is the central monetary authority which manages the currency and credit policy of the country and functions as a banker to the government as well as to the commercial banks. It is difficult to define central bank accurately. However, different definitions have been given emphasising one or more functions of the central bank. **De Kock** defined central as *"a bank which constitutes the apex of the monetary and banking structure of the country."*[1] According to **Vera Smith**, *"the primary definition of central bank is a banking system in which a single bank has either a complete or a residuary monopoly of note issue."*[2] According to the **Bank for International Settlements**, a central bank is defined as *"the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in that country."* In the words of **Kent**, a Central bank is an *"institution charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of general public welfare."*[3]

Growth of Central Banking

Central banking is a recent phenomenon mainly related to 19th and 20th centuries, although certain central banking functions were performed by certain insititutions in the olden days. The growth of central banks has been very slow. The Riks Bank of Sweden is the earliest bank established in 1656. The Bank of England, though founded in 1694, started functioning as the central bank with the passing of the Bank Charter Act, 1882. Other major countries which established central banks in the 19th century are France (1800), Netherlands (1814), Russia (1860), Germany (1875), Japan (1882), etc. The movement of central banking started in the 20th century, particularly after the International Financial Conference meeting at Brussels in 1920 which suggested the opening of central banks in all countries. It gained momentum after the establishment of International Monetary Fund in 1947. The Federal Reserve system in the U.S.A. was established in 1913 and the Reserve Bank of India in 1935. Today, there is hardly any country which does not have a central bank. Initially, the central banks were privately owned and privately managed joint stock banks. But, now, particularly after World War II, most of the central banks have been nationalised or have been set up as state-owned institutions.

Difference between Central Bank and Commercial Bank

There are certain basic differences between a central bank and a commercial bank. They are :

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

(*ii*) The central bank does not operate with a profit motive. The primary aim of the central bank is to achieve the objectives of the economic policy of the government and maximise the public welfare

1. De Kock : *Central Banking* (3 rd Ed), p.22.
2. Vera Smith : *Rationale of Central Banking*, p. 148.
3. R.P. Kent : Money and Banking (5th Ed.), p. 338.

through monetary measures. The commercial banks, on the other hand, have profit earning as their primary objective.

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

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

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

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

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

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

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

2. FUNCTIONS OF CENTRAL BANK

The central bank generally performs the following functions :

1. Bank of Note Issue. The central bank has the sole monopoly of note issue in almost every country. The currency notes printed and issued by the central bank become unlimited legal tender throughout the country. In the words of De Kock, "The priviledge of note-issue was almost everywhere associated with the origin and development of central banks." However, the monopoly of central bank to issue the currency notes may be partial in certain countries. For example, in India, one rupee notes are issued by the Ministry of Finance and all other notes are issued by the Reserve Bank of India.

The main advantages of giving the monopoly right of note issue to the central bank are given below :

(*i*) It brings uniformity in the monetary system of note issue and note circulation.

(*ii*) The central bank can exercise better control over the money supply in the country.

(*iii*) It increases public confidence in the monetary system of the country.

(*iv*) Monetary management of the paper currency becomes easier. Being the supreme bank of the country, the central bank has full information about the monetary requirements of the economy and, therefore, can change the quantity of currency accordingly.

(*v*) It enables the central bank to exercise control over the creation of credit by the commercial banks.

(*vi*) The central bank also earns profit from the issue of paper currency.

(*vii*) Granting of monopoly right of note issue to the central bank avoids the political interference in the matter of note issue.

2. Banker, Agent and Adviser to the Government. The central bank functions as a banker, agent and financial adviser to the government. (*a*) *As a banker to government*, the central bank performs the same functions for the government as a commercial bank performs for its customers. It maintains the accounts of the central as well as state government; it receives deposits from government; it makes short-term advances to the government ; it collects cheques and drafts deposited in the government account ; it provides foreign exchange resources to the government for repaying external debt or purchasing foreign goods or making other payments. (*b*) *As an Agent to the government*, the central bank collects taxes and other payments on behalf of the government. It raises loans from the public and thus manages public debt. It also represents the government in the international financial institutions and conferences. (*c*) *As a financial adviser to the government*, the central bank gives advise to the government on economic, monetary, financial and fiscal matters such as deficit financing, devaluation, trade policy, foreign exchange policy, etc.

3. Bankers' Bank. The central bank acts as the bankers' bank in three capacities : (*a*) custodian of the cash reserves of the commercial banks; (*b*) as the lender of the last resort; and (*c*) as clearing agent. In this way, the central bank acts as a friend, philosopher and guide to the commercial banks.

As a *custodian of the cash reserves* of the commercial banks the central bank maintains the cash reserves of the commercial banks. Every commercial bank has to keep a certain percentage of its cash balances as deposits with the central banks. These cash reserves can be utilised by the commercial banks in times of emergency.

The centralisation of cash reserves in the central bank has the following advantages :

(*i*) Centralised cash reserves inspire confidence of the public in the banking system of the country.

(*ii*) Centralised cash reserves provide the basis of a larger and more elastic credit structure than if these amounts were scattered among the individual banks.

(*iii*) Centralised reserves can be used to the fullest possible extent and in the most effective manner during the periods of seasonal strains and financial emergencies.

(*iv*) Centralised reserves enable the central bank to provide financial accommodation to the commercial banks which are in temporary difficulties. In fact the central bank functions as the lender of the last resort on the basis of the centralised cash reserves.

(*v*) The system of contralised cash reserves enables the central bank to influence the creation of credit by the commercial banks by increasing or decreasing the cash reserves through the technique of variable cash-reserve ratio.

(*vi*) The cash reserves with the central bank can be used to promote national welfare.

4. Lender of Last Resort. As the supreme bank of the country and the bankers' bank, the central bank acts as the lender of the last resort. In other words, in case the commercial banks are not able to meet their financial requirements from other sources, they can, as a last resort, approach the central bank for financial accommodation. The central bank provides financial accommodation to the commercial banks by rediscounting their eligible securities and exchange bills.

The main *advantages* of the central bank's functioning as the lender of the last resort are :

(*i*) It increases the elasticity and liquidity of the whole credit structure of the economy.

(*ii*) It enables the commercial banks to carry on their activities even with their limited cash reserves.

(*iii*) It provides financial help to the commercial banks in times of emergency.

(*iv*) It enables the central bank to exercise its control over banking system of the country.

5. Clearing Agent. As the custodian of the cash reserves of the commercial banks, the central bank acts as the clearing house for these banks. Since all banks have their accounts with the central bank, the central bank can easily settle the claims of various banks against each other with least use of cash.

The clearing house function of the central bank has the following *advantages* :

(*i*) It economises the use of cash by banks while settling their claims and counter-claims.

(*ii*) It reduces the withdrawals of cash and these enable the commercial banks to create credit on a large scale.

(*iii*) It keeps the central bank fully informed about the liquidity position of the commercial banks.

6. Custodian of Foreign Exchange Reserves. The central bank also functions as the custodian of country's foreign exchange reserves. This function helps the central bank to overcome the balance of payments difficulties and to maintain stability in the exchange rates. In order to minimise the fluctuations in the foreign exchange rates, the central bank buys (or sells) foreign currencies in the market as the value of foreign currencies falls (or rise).

7. Controller of Credit. Controlling credit is the most-important function of the central bank. In the words of **De Kock**, ***"It is the function which embraces the most important question of central banking policy and the one through which practically all the functions are united and made to serve a common purpose."*** Uncontrolled credit causes economic fluctuations in the economy. By controlling the credit effectively the central bank establishes stability not only in the internal price level, but also in the foreign exchange rates. Such a stability is necessary for economic growth and smooth functioning of the economy.

8. Developmental Role. In the underdeveloped or developing country, the central bank, besides performing the traditional functions, also performs developmental and promotional functions. In these countries the central bank, on the one hand, helps to develop money and capital markets and on the other hand, undertakes suitable measures to promote economic development and maintain price and exchange rate stability.

9. Other Functions. The central bank also performs certain other miscellaneous functions . (*a*) It maintains relations with international institutions, such as the I.M.F., World Bank, etc. (*b*) It collects various types of statistics providing information about current state of the economy. (*c*) It conducts surveys, seminars etc. and publishes reports on other matters. (*d*) It helps in developing the banking system and banking habits in the country. (*e*) It formulates appropriate monetary policy to deal with economic crisis in the country. (*f*) It extends training facilities to the staff working in various banking institutions.

Conclusion. In short, the central bank functions as the supreme monetary institution in the country by acting as a banker to the government and to the commercial banks; a controller of the monetary system of the country : and a promoter of economic growth with stability. It performs these functions with out any profit motive and in the interest of the general public.

3. ROLE OF CENTRAL BANK IN DEVELOPING COUNTRIES

In the developing countries, the central bank has to play a much wider role. Besides performing the traditional functions, the central bank has to undertake responsibility of economic growth with stability in these economies. Moreover, since the developing countries do not have well-organised money and capital markets, the central bank has a crucial function to develop the banking and financial system of the country.

Tho central bank performs the following developmental and promotional functions in the developing countries :

1. Traditional Functions. The central banks in the developing countries perform both traditional and non-traditional functions. The traditional functions of the central bank are : having the monopoly of note-issue; acting as banker to the government; serving as bankers' bank; functioning as the lender of the last resort; controlling and regulating the credit; and maintaining the external stability.

2. Economic Growth. The central banks in the developing countries should aim at promoting the process of economic growth. Economic growth requires sufficient financial resources. The central bank can ensure adequate monetary expansion in the country. Moreover, as a banker to the government, the central bank can provide funds for initiating investment in the public sector.

3. Internal Stability. Along with the objective of economic growth, the central bank should also attempt to maintain internal price stability. The developing countries are susceptible to inflationary pressures mainly due to supply inelasticities in the short period. The central bank should adopt such a monetary policy that can control inflationary tendencies and ensure price stability.

4. Development of Banking System. The developing and underdeveloped countries do not have well-developed banking system. In such an economy, the central bank should not only take measures to develop an integrated commercial banking system, but also should not hesitate undertaking directly the commercial banking functions.

5. Branch Expansion. In developing countries, the commercial banks generally concentrate their branches in the urban areas. In order to extend credit facilities to the agricultural sector, the central bank should prepare programme for branch expansion in the rural areas.

6. Development of Financial Institutions. Development of the leading sectors of the economy such as agriculture, industry, foreign trade, etc. requires long-term finances. For this, the specialised financial institutions should be established which provide term-loans to these sectors.

7. Development of Banking Habits. Through its various credit control instruments (*i.e.*, bank rate, variable cash-reserve ratio, etc.) and by providing discounting facilities to the commercial banks, the central bank exercises full control over the activities of commercial banks. This creates public confidence in the banking system and helps in the development of banking habits of the people.

8. Training Facilities. A major difficulty in developing the banking system in developing countries is the lack of trained staff. The central bank can provide training facilities to meet the personnel requirements of the banks.

In the end, according to De Kock, *"The most recent tendency in the official monetary circles is to combine the objective of international exchange stability with that of promoting and maintaining high levels of employment and real income."*[1]

5. METHODS OF CREDIT CONTROL

The various methods or instruments of credit control used by the central bank can be broadly classified into two categories : (*a*) quantitative or general methods, and (*b*) qualitative or selective methods.

1. Quantitative or General Methods. The methods used by the central bank to influence the total volume of credit in the banking system, without any regard for the use to which it is put, are called quantitative or general methods of credit control. These methods regulate the lending ability of the financial sector of the whole economy and do not discriminate among the various sectors of the economy. The important quantitative methods of credit control are : (*a*) bank rate, (*b*) open market operations, and (*c*) cash-reserve ratio.

2. Qualitative or Selective Methods. The methods used by the central bank to regulate the flows of credit into particular directions of the economy are called qualitative or selective methods of credit control. Unlike the quantitative methods, which affect the total volume of credit, the qualitative methods affect the types of credit extended by the commercial banks ; they affect the composition rather than the size of credit in the economy. The important qualitative or selective methods of credit control are ; (*a*) marginal requirements, (*b*) regulation of consumer credit, (*c*) control through directives, (*d*) credit rationing, (*e*) moral suasion and publicity, and (*f*) direct action.

6. BANK RATE POLICY

The bank rate policy is the traditional method of credit control used by a central bank. The bank rate or the discount rate is the rate at which a central bank is prepared to discount the first class bills of exchange. According to M. Spalding, the bank rate is ***"the minimum rate charged by the central bank for discounting approved bills of exchange."*** In its capacity as 'lender of last resort', the central bank helps the commercial banks by rediscounting the first class bills (*i.e.*, by advancing loans against approved securities). The rate of interest which the central bank charges from the commercial banks for rediscounting the bills is called bank rate.

The bank rate is distinct from the market interest rate. The bank rate is the rate of discount of the central bank, while the market interest rate is the lending rate charged in the money market by the ordinary financial institutions There is a direct relationship between the bank rate and the market interest rates. A change in the bank rate leads to change in other interest rates prevailing in the market. In this sense, bank rate is the effective rate for lending or borrowing which prevails in the market.

Bank rate policy aims at influencing (*a*) the cost and availability of credit to the commercial banks. (*b*) interest rates and money supply in the economy, and (*c*) the level of economic activity of the economy. A rise in the bank rate makes the credit costlier, reduces the volume of credit, discourages economic activity and brings down the price level in the economy. Similarly, a fall in the bank rate makes the credit cheaper, increases the volume of credit, encourages the businessmen to borrow and invest, and increases the levels of economic activity and the price level.

Effects of Bank Rate Policy

Various effects of bank rate policy are discussed below :

1. Effect on Cost and Availability of Credit. Bank rate policy influences both the cost and the availability of credit to the commercial banks. By changing the bank rate, the central bank affects the cost of credit : by raising the bank rate, it raises the cost of credit and by lowering the bank rate, it lowers the cost of credit. By changing the eligibility rules or the conditions under which the commercial banks can secure loans the central bank influences the availability of credit ; strict eligibility rules make it difficult, and lenient

1. De Kock : *Central Banking*, p. 138.

eligibility rules make it easy, for the commercial banks to get loans from the central bank. The cost of credit (or the price dimension of the bank rate policy) determines the quantity of borrowing demanded from the central bank and the availability of credit (or the quantity dimension of the bank rate policy) determines the quantity supplied by the central bank. When quantity demanded is equal to the quantity supplied, a zero change in the bank rate policy will be appropriate.

2. No Simultaneous Determination of Interest Rates and Money Supply. The central bank, through its bank rate policy, is able to influence the interest rates and the money supply in the economy. Changes in the bank rate influence the interest rates in the money market. Changes in the amount that the central bank is willing to lend influence the money supply. But, the central bank cannot simultaneously set both interest rates as well as the money supply. It must choose one goal or the other.

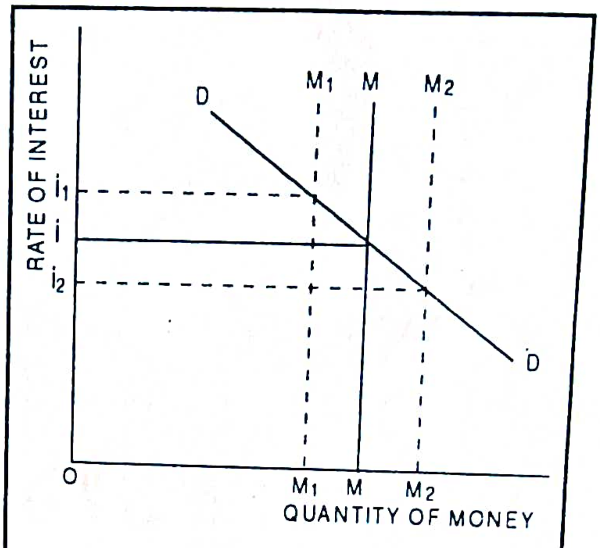

Fig. 1.

In Figure 1, DD is the community's demand for money curve. MM is the supply of money curve. Oi is the rate of interest. Given the demand for money curve, DD, if the central bank wants the rate of interest to rise from Oi to Oi_1, it must reduce the supply of money from OM to OM_1; and if it wants the rate of interest to fall from Oi to Oi_2, it must increase the money supply from OM to OM_2. Similarly, if the central bank desires to reduce the money supply from OM to OM_1, it must raise the interest rate from Oi to Oi_1; and if it desires to increase the money supply from OM to OM_2, it must reduce the interest rate from Oi to Oi_2. Thus, given the demand for money function, the central bank cannot simultaneously choose an interest rate and the money supply.

3. Effect on the Level of Economic Activity. The bank rate policy affects the level and structure of interest rates and thereby the level of economic activity in an economy. A change in the bank rate leads to a corresponding change in the other interest rates of the market. This makes credit either dearer or cheaper. The changes in the market interest rates affect the willingness of the businessmen to borrow and invest. This will, in turn, affect the level of economic activity and the price level.

4. The Announcement Effect. The announcement effect of a change in the bank rate influences the credit psychology in the economy. A rise in the bank rate is regarded as the official signal for the beginning of the period of relatively dearer money and a fall in the bank rate is an indication for the onset of a cheaper money phase.

5. Bank Rate Policy During Inflation and Depression. Bank rate policy is used to control the inflationary as well as deflationary situations in the economy. During inflation, the central bank increases the bank rate. As a result, other interest rates in the money market will rise, thereby rising the cost of bank credit.This will discourage the businessmen from borrowing from banks. The Volume of credit will decrease, the level of economic activity will decline and the price level will fall.

During depression, the bank rate is reduced. It will reduce the market rates of interest, make the bank credit cheaper, encourage the businessmen to borrow, and invest, push up the level of economic activity and the price level.

6. Effect on Balance of Payment. A rise in the bank rate will set right an adverse balance of payment. An adverse balance results in an outflow of gold. As the bank rate is raised, other interest rates in the money market go up. As a result, there will be a movement of foreign capital into the country because of better returns and stoppage of capital going out of the country. Moreover, the demand for domestic currency will rise, raising its value and making the exchange rate more favourable.

Hawtrey and Keynes on Bank Rate Policy

Hawtrey and Keynes have developed different lines of thought regarding the effect of bank rate policy. According to Hawtrey, the bank rate policy alters the short-term interest rates in the market, which influence the level of economic activity in the economy. Keynes, on the other hand, was of the view that the economic activity in the economy is influenced by the effect of the bank rate on the long-term interest rates.

According to Hawtrey, changes in the bank rate result in changes in the short-term interest rates which, in turn, influences the cost of borrowing from the commercial banks and the willingness of the dealers to hold stocks of finished goods through bank loans. This will affect the economic activity in the economy. When the bank rate rises, short-term interest rates rise consequently. This discourages the traders to hold finished goods because now the cost (i.e., interest burden) of holding such stock has risen. They will curtail their existing stocks of finished goods and also reduce their orders with the industrialists. In view of falling orders, the industrialists will reduce production and employment. Unemployment of workers will reduce general demand for goods and services, and, thereby their prices. Thus, raising the bank rate, through raising the short-term interest rates, adversely affects the holding of stocks and reduces the business activity in the economy.

According to Keynes, changes in the bank rate cause changes in the short-term as well as long-term rates of interest that influence the economic activity. When the bank rate rises, the commercial banks immediately raise interest rates. As a result, the investors tend to avoid borrowing from the banks and tend to raise funds by selling long-term securities. The large sales of long-term securities and the resultant diversion from long-term to short-term securities will lower the prices and raise the interest rates of long-term securities. Thus, whenever bank rate rises, the short-term interest rates go up immediately and after a while long-term interest rates also move upward. As a result of rise in the long-term interest rates, given the marginal efficiency of capital, the businessmen will reduce their investment and the reduction in investment will result in contraction in economic activity, leading to a fall in production, employment and prices.

In fact, the two economists emphasised two different aspects of the same problem. While Hawtrey emphasised the effectiveness of short-term interest rates in influencing the level of economic activity, Keynes emphasised the effects of change in the long- term interest rates on the level of economic activity. The correct approach would be to integrate the two views to have a complete understanding of the influence of the bank rate policy on the volume of credit and level of economic activity.

Assumptions of Bank Rate Policy

The success of the bank rate policy is based on the following assumptions :

(*i*) The commercial banks possess sufficient quantities of eligible securities.

(*ii*) Commercial banks are not prejudiced against rediscounting their eligible securities with the central bank.

(*iii*) Commercial banks keep only minimum cash reserves just sufficient to carry on their day-to-day operations. For additional cash requirements they freely approach the central bank.

(*iv*) There exists a close relationship between the bank rate and other interest rates.

(*v*) Borrowing and investment of the businessmen depend upon the prevailing interest rates of the commercial banks. In other words, a rise in the interest rate restricts borrowings and investment, while a fall in the interest rate encourages borrowing and investment.

(*vi*) There exists an elastic economic structure. In other words, prices, costs, wages, employment, and production are flexible enough to change according to the changes in borrowing and investment by businessmen.

(*vii*) There exist no artificial restrictions on the international flow of capital.

Limitations of Bank Rate Policy

The effectiveness of the bank rate policy depends on the fulfillment of a number of assumptions. As these assumptions are not fully achieved in reality, the bank rate policy suffers from a number of limitations :

1. Insensitivity of Investment. The Radcliffe Committee in Great Britain and the American Committee on Money and Credit have pointed out that the entrepreneurs are not very sensitive to changes in the interest rates while making their investment decisions. The investment decisions are influenced more by business expectations than by changes in the rate of interest. During boom period, when the businessmen are overoptimistic and the marginal efficiency of capital is high, the demand for bank cr edit cannot be easy checked by increasing the bank rate.

2. Ineffective in Controlling Deflation. Bank rate policy is more ineffective in off-setting depression than in controlling inflation. When bank rate is lowered during a period of deflation, the resulting lower rates of interest may not be able to induce the entrepreneurs to borrow and invest more because of falling prices and falling profits.

3. Conflicting Effects. The internal and external effects of the bank rate policy may be conflicting. If, for example, the bank rate is raised to control domestic inflation, the resulting rise in other interest rates may attract short-term foreign funds into the country. This may offset the anti-inflationary effects of the bank rate policy.

4. Ineffective in Controlling Balance of Payments disequilibrium. The success of bank rate policy in correcting the balance of payments disequilibrium presupposes the removal of all artificial restrictions on foreign exchange and on the international flow of capital. But, in reality this condition is nowhere satisfied.

5. Indiscriminatory. The bank rate policy is indiscriminatory in nature. In other words, it makes no distinction between the productive and unproductive activities in the country. For example, if the bank rate is raised to control speculative activities, it will also adversely affect the genuine productive activities.

6. Non-Dependence of Commercial Banks. In modern times, the commercial banks have acquired sufficient liquid resources of their own. As a result, they have become more and more independent and do not feel the necessity to approach the central bank for financial accommodation.

Effectiveness of Bank Rate Policy in Under-developed Countries

The necessary conditions for the success of bank rate policy are more satisfied in the developed countries than in underdeveloped countries. In the underdeveloped countries, the bank rate policy has been called into question due to the following reasons :

(*i*) In the underdeveloped countries, the money market is divided into two sectors : (*a*) the modern banking sector : and (*b*) the indigenous banking sector. While the bank rate policy may be effective in the modern banking sector, comprising commercial banks, it has no effect on the indigenous bankers (*e.g.*, sahukars, money lenders, etc) who are not dependent on the central bank for financial accommodation.

(*ii*) The modern banking sector in the underdeveloped countries lack coordination among its constituent units so that the bank rate policy does not become fully effective.

(*iii*) Most of the commercial banks in the underdeveloped countries are in the habit of keeping excess cash reserves over and above the minimum requirements. This reduces their dependence on the central bank for financial accommodation.

(*iv*) In the underdeveloped countries, there is no availability of eligible securities in large quantity to be rediscounted from the centre banks.

(*v*) The presence of substantial non-monetised sector (*i.e.*, barter transactions) also render bank rate policy ineffective in the underdeveloped countries.

(*vi*) The. economics of the underdeveloped countries are far from elastic in the sense that wages, costs and prices do not respond readily to changes in the volume of credit.

(*vii*) The empirical evidence suggests that investment expenditure in the underdeveloped countries is generally interest-inelastic. This is mainly because of the fact that interest cost forms a very low proportion of total cost of investment in these countries.

(*viii*) In planned developing economies where the public sector accounts for the larger part of the nation's investment and is equipped with a set of more direct and powerful instruments of controlling the level of economic activity, the bank rate loses much of its importance.

Decline of Bank Rate Policy

The bank rate policy remained successful during the prevalence of international gold standard. But, after the Great Depression of 1929-33, the importance of the bank rate as a method of credit control declined.

The various factors responsible for the decline of the bank rate policy are given below :

1. Decline in Bills of Exchange. The bank rate operates through rediscounting of bills of exchange But, after the World War I, there has been a marked decline in the use of bills of exchange as an instrument of financing trade mainly due to the contraction of international trade and the increasing use of treasury bills or other short-term government securities.

2. Economic Rigidities. The growing tendency of almost all countries after the World War I towards economic regidities, such as stabilisation of prices, wages, interests, etc, has reduced the importance of bank rate.

3. Importance of Fiscal Policy. The cheap money policy followed by most of the governments during and after the Great Depression of 1930 failed to revive economic activities. On the other hand, fiscal policy proved quite effective in offsetting the effects of depression. Thus, the monetary policy receded into the back- ground and the fiscal policy gained more and more importance.

4. Increased Deposits. The deposits of commercial banks have also increased due to the inflationary conditions. As a result of their strong financial position, the commercial banks do not approach the central bank for financial accommodation.

5. Other Methods. In recent years, other and more effective methods of credit control such as open market operations, variable cash reserve ratios, selective credit controls, etc, have been developed. These methods have caused a further decline in the importance of bank rate policy.

6. Less Sensitive to Changes in Interest Rates. Recent changes in taxation and production costs have made the businessmen less sensitive to the changes in the rates of interest.

7. Changing Methods of Business Financing. Recent changes in the methods of business financing have also reduced the importance of interest rates and hence of the bank rate in investment decisions. The businessmen now resort more to ploughing back of profits and accumulation of surplus funds and less to borrowing from commercial banks for financing their economic activities.

Significance of Bank Rate Policy

Though the bank rate policy suffers from serious limitations and though it has not proved very effective in both developed and underdeveloped countries, Its importance as a useful weapon of credit control, particularly in fighting inflationary pressures in the economy cannot be underestimated. To use the words of De Kock, *"The discount rate of central bank has nevertheless a useful function to perform in certain circumstances and in conjunction with other measures of control."*[1]

The significance of the bank rate policy is three fold :

(*i*) The bank rate indicates the rate at which the public can get accommodation against the approved securities from the banks.

(*ii*) The bank rate indicates the rate at which the commercial banks can get accommodation from the central bank against the government and other approved securities.

(*iii*) The bank rate reflects the credit situation and economic condition in the country. A rise in the bank rate may be regarded as "the amber coloured light of warning" to the commercial credit and business activities, while a fall in the bank rate may be looked upon as "the green light indicating that the coast is clear and the ship of commerce may proceed on her way with caution."[2]

7. OPEN MARKET OPERATIONS

"In view of the shortcomings of the bank rate policy, the development of open market operations-the purchase and sale of government securities and other credit instruments in the open market-as an additional and, to some extent, alternative instrument of central bank policy is a logical step."[3] Open market operations refer to the deliberate and direct buying and selling of securities in the money market by the central bank. In the narrow sense, open market operations refer to the purchase and sale by the central bank of government securities in the money market. In the broad sense, open market operations imply the purchase and sale by the

1. De Kock : *Central Banking*, p.182.
2. *Lbid*, p.182.
3. G.N. Halrn : *Monetary Theory*, p. 59.

central bank of any kind of eligible paper, like, government securities, bills and securities of private concerns, etc.

Effects of Open Market Operations

When the central bank purchases or sells securities in the open market, it affects the economy in the following ways :

1. Effects on Reserves of Commercial Banks. Open market operations bring changes in the reserves of the commercial banks. When the central bank purchases securities, the reserves of the banks increase exactly by the same amount of the purchase. The banks will expand credit multiple times which will ultimately lead to an increase in the level of economic activity. Opposite effects will be obtained when the central bank sells securities.

2. Effect on Interest Rates. Purchase or sale of securities affects their prices as well as their yields. When the central bank purchases securities aggressively, it increases their prices and thereby lowers their yields. Similarly, an aggressive sale of securities will lowers their prices and raise their yields. Price of securities are inversely related to the interest rates (or yields). Hence, open market operations can also affect interest rates.

3. Effect on Future Expectations. Open market operations can also affect the economy by changing expectations about the future interest rates. An increase in the purchase of securities by the central bank may be interpreted as an expansionary monetary policy. This will lower interest rates, increase investment, production and employment, and raise consumer spending and prices. On the other hand, expansionary monetary policy may induce expectations of increased inflation in future which will discourage investment and consumption spending. Thus, nothing specific can be said as to how expectations change as a result of change in the open market operations.

4. Simultaneous Determination of Interest Rate and Money Supply. The central bank, through open market operations, cannot simultaneously fix the security price (*i.e.*, interest rate) and the reserves of the commercial banks (*i.e.*, money supply). If the central bank wants to fix the security price, and thus the interest rate, below (or above) the natural rate of interest, *i.e.*, the market determined rate of interest rate, it must be prepared to buy (or sell) an unlimited quantity of securities at the fixed lower (or higher) price, and must accept an increase (or decrease) in the reserves of commercial banks and thus in money supply. Similarly, if the central bank wants to use the open market operations policy to change the money supply in the desired directions, it must surrender its control over the interest rate and must allow it to go where it will go.

5. Open Market Operations policy During Inflation. During inflation, with an objective to reduce the volume of credit, the central bank sells securities to the public for which it receives payment by cheque drawn on commercial banks. This reduces the cash reserves of the commercial banks. A fall in the cash reserves of the commercial banks reduces their ability to create credit and results in multiple contraction in the total volume of credit due to the operation of credit multiplier. Thus, investment activity which is based on the bank loans will be curtailed.

6. Open Market Operations Policy During Depression. During depression, the central bank attempts to increase the volume of credit by purchasing the securities from the public. The payment made by the central bank to the sellers is through cheques which are deposited with the commercial banks. This increases the cash reserves and the credit creation capacity of the banking system. Thus, the loans and advances from the commercial banks increase which result in the expansion of investment, employment, output and prices.

7. Effect on Balance of Payments. Open market operations policy may be used to influence the balance of payments favourably. For example, the selling of securities by the central bank will contract the volume of credit and generate a deflationary situation, thus reducing the domestic price level. As a result of this, the country's exports will increase because of increased foreign demand due to lower prices ; and imports will decline because the prices in the foreign countries are relatively higher. Thus, a favourable balance of payments will be achieved.

Objectives of Open Market Operations Policy

The policy of open market operations, by directly changing the cash reserves with the commercial banks, attempts to influence the total volume of credit created in the system and ultimately the level of economic activity and the price level of the country.