5 Meaning, Functions and Supply of Money

Contents

Money plays an important role in all economies. People want money not for itself but for things it will buy. Money is the basic necessity of every economy. The main function of money is to facilitate the exchange of goods and services. In this chapter, we will study the meaning and functions of money. Before money was invented all economic transactions were carried on the basis of barter system. So before we come to know the meaning and functions of money, we will briefly explain the barter system.

1. Barter System of Exchange

1.1 Meaning of Barter Exchange

In the initial phases of human civilization, human needs were simple and limited. People used to exchange goods with each other to satisfy their wants. *Barter means exchange of goods for goods.* An economy, where there is a direct barter of goods and services, is called a **'Barter Economy' or 'C - C Economy'** (where C - C stands for commodity to commodity).

1. Difficulties of Barter System

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Barter system of exchange suffers from the following drawbacks.

(1) **Lack of double coincidence of wants :** The barter system requires a double coincidence of wants on the part of those who want to exchange goods or services. For example, suppose a farmer possesses wheat and wants to exchange it for cloth. In the barter system, he has to find out a person who not only has cloth but also wants wheat in return. But, such a double coincidence is a rare possibility. Imagine how much effort (physical labour) it will require to find such a person. Moreover, it also involves waiting for the appropriate person. Waiting involves discomforts which implies disutility. **Efforts and disutility of discomforts taken together is called trading cost of barter exchange.**

(2) **Lack of common measure of value :** Another difficulty of barter is that at what rate any exchange is to be made. There is lack of common measure of value. For example, if there are 1000 goods in the market then the value of each would have to be expressed in terms of 999 goods. The price list then becomes extremely complicated. Not only this, no proper accounting is possible in the absence of common unit of value.

(3) **Problem of future payments :** Thirdly, the barter system lacks a standard of deferred payments. In the absence of money, future payments are not possible because of the following reasons:

(a) The borrower may not be able to arrange exactly the same good and of the same quality at the time of repayment.

(b) There could be disagreement regarding which specific commodity would be used for repayment.

(c) There exists a risk since the commodity may increase or decrease in its value at the time of repayment.

(4) **Problem of storing of value :** Lastly, the barter system does not provide a reliable method of storing value or wealth for future use. Storing of value means storing of the purchasing power i.e., storing of income for future use . Under barter system, it is difficult for people to store wealth for future use. Most of the goods like wheat, rice, vegetables etc. do not possess durability and their quality deteriorates with passage of time. Further, storage of goods require time, money and efforts. It makes their storage very difficult. As a result, goods cannot be used to store wealth for future use.

Due to these above mentioned drawbacks of the barter system, the process of exchange becomes highly inefficient. To overcome these difficulties, money was invented by the society.

2. Meaning of Money

Money has been defined by different economists differently. Some have defined it in terms of its general acceptability while others have defined it in terms of its functions. Basically, money was introduced as an instrument (or medium) of exchange. Accordingly, money meant anything that act as medium of exchange. With the passage of time, money came to be defined differently. The important definitions of money are explained under the following heads :

2.1 Legal definition of money

According to this definition, *money is what the law says is money.* In other words, anything which the government declares it as money is money. A thing will have general acceptability if the law declares it as money. Since it has the legal power to discharge debts, no creditor can refuse it or he may not demand anything else in payment of debt. Currency-notes and coins are **legal tender money.** It is also called **fiat money** because it serves as money on the fiat (order) of the government.

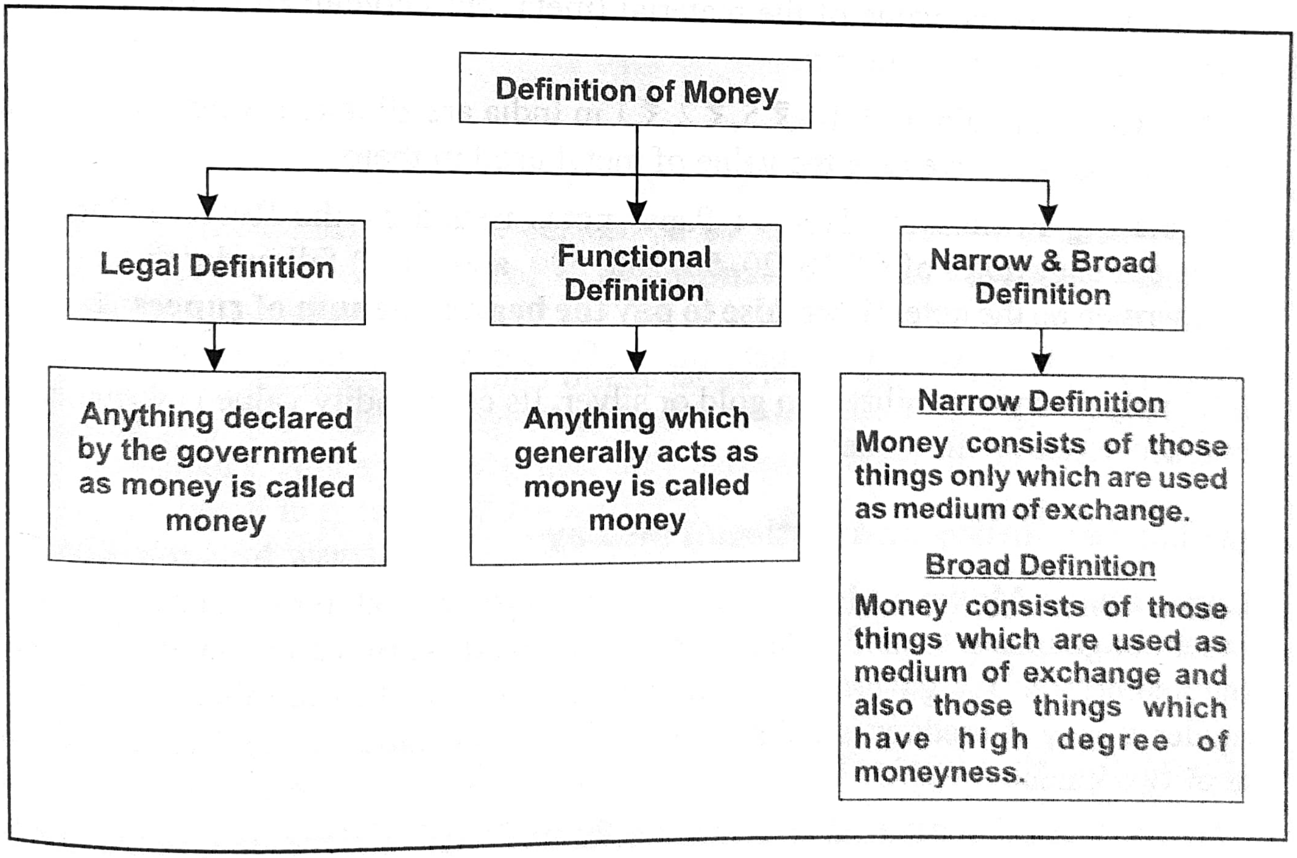
2.2 Functional definition of money

According to this definition, money is defined on the basis of functions it performs. This definition emphasizes the important functions of money. From this point of view **Crowther's definition** is considered as most suitable definition of money. He defines money as **'anything that is generally acceptable as a medium of exchange and at the same time acts as a measure and as store of value'.**

This is an ideal definition of money because of two reasons :

(i) This definition emphasizes all the important functions of money.

(ii) It stresses upon the basic characteristic of general acceptability.



2.3 Narrow and broad definitions of money

On the basis of scope, money has been defined in two ways : (i) narrow money and (ii) broad money. Narrow money includes only currency notes and coins. It includes only those things which function as medium of exchange. On the other hand, broad money, besides including currency notes and coins, also includes some other things in the supply of money that have high degree of moneyness e.g., time deposits at banks and post offices. These deposits can be converted into ready cash at short notice.

3. Classification of Money

Money can be classified as under :

3.1 Full Bodied Money

Full bodied money is that money whose value as a commodity is equal to its value as money. It is also called standard money. When the economies of the world were on gold standard or silver standard, gold coins or silver coins were full bodied money. A rupee coin during the British period in India was made of silver. Its commodity value (i.e., metallic value or intrinsic value) was equal to its money value (i.e., face value).

3.2 Credit Money

Credit money refers to that money whose value as money is greater than its commodity value (i.e., value of the material from which it is made). It means face value is greater than intrinsic value. Intrinsic value is the value of the material (metal etc.) contained in the unit of money. Credit money includes the following:

(a) **Token Coins :** (Coins of ₹ 10, ₹ 5, ₹ 2, ₹ 1 in India are all token coins) since their value as money is far above than the value of metal used in them.

(b) **Circulating Promissory Notes :** Paper notes issued by the Reserve Bank of India (e.g., currency notes of ₹ 5,10, 20, 50, 100, 500, and 1000) fall under this category. We find written on the note, **'I promise to pay the bearer the sum of rupees'** signed by the Governor of RBI. Any note is just a piece of paper with a promise on it. These words do not imply its convertibility into gold or silver. Its commodity value is virtually nothing and hence it is credit money.

3.3 Legal Tender Money and Optional Money

(a) **Legal Tender Money :** Money which can be legally used to make payment of debt or other obligations is termed as legal tender money. It is also called fiat money as runs by the authority of the government. Currency notes and coins are therefore, called legal tender money. A creditor is obliged by law to accept such money. Legal tender money is of two kinds :

(i) **Limited Legal Tender :** It refers to that form of legal tender money which can be paid in discharge of a debt upto a certain limit. Beyond this limit, a person may refuse to accept the payment and no legal action can be taken against him. In India, coins are limited legal tender.

(ii) **Unlimited Legal Tender :** It refers to that form of legal tender money which can be paid upto any extent. A person has to accept without any maximum limit. Legal action

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can be taken against a person who refuses to accept this money. In India, paper notes are unlimited legal tender.

Optional Money : It refers to that form of money which is generally accepted as a medium of exchange, but legally, there is no compulsion to accept it. For example, cheques, bank drafts etc. do not have legal boundation. One may accept or refuse them. It is also called **fiduciary money** as it is accepted as money on the basis of trust between the payer and payee.

3.4 Bank Money

Bank money refers to the demand deposits of the people at banks. These deposits are payable on demand. Bank money facilitates the exact amount of payments through cheques, drafts etc. It is also called **deposit money**. Bank money is optional. A person may or may not accept the payment through cheque or draft etc.

4. Functions of Money

Money performs several important functions. These functions are classified into two categories :

(1) Primary functions and

(2) Secondary functions

4.1 Primary Functions

Primary functions refers to those functions which are the basic and essential functions of money. These functions must be performed by money in every economy and under all circumstances. These are also referred to as **original functions** of money. Following are the two primary functions of money :

1. **Medium of exchange :** Medium of exchange is the most important function of money. Money is generally and widely accepted as the medium of exchange. All purchases or sales are made through money. Since money is generally accepted, everyone accepts it in exchange for goods and services. It thus removed the difficulty of barter system by eliminating the need for double coincidence of wants.

Importance : While functioning as medium of exchange, money benefits the society in many ways:

(a) It overcomes the difficulties of barter exchange.

(b) It increases the ease of trade. Accordingly, it raises the level of production substantially.

(c) It allows freedom of choice as every person can buy goods of his choice from people who offer him best bargain

2. **Measure of value or unit of account :** The second primary function of money is that it acts as a common measure of value or unit of account. *Money as a measure of value means a standard unit for quoting prices.* Money acts as a standard measure of value into which the

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value of all goods and services are expressed and compared. When we express the value of a commodity in terms of money, it is known as **price**.

Importance

(i) Measuring values in monetary units helps in measuring the exchange values of commodities. For example, if price of sugar is ₹ 30 per kg. and that of wheat is ₹ 10 per kg., then one kg. of sugar is worth 3 kg. of wheat.

(ii) Further, accounting is simplified, as all items are recorded in terms of monetary units that can be added and subtracted.

4.2 Secondary Functions

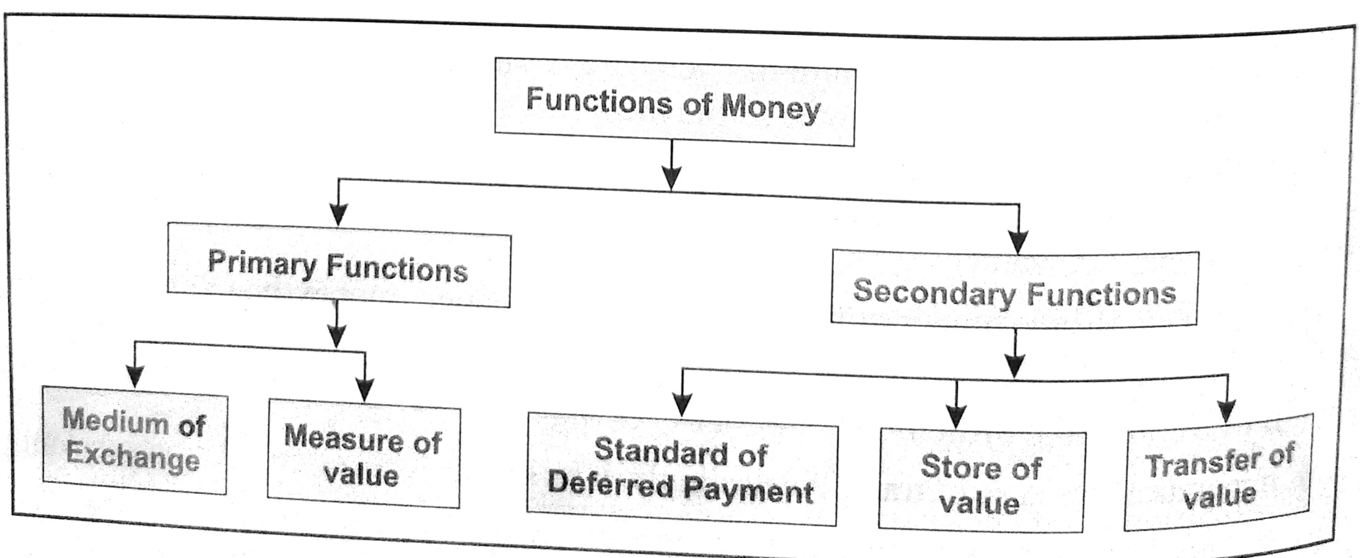
Secondary functions are complementary to the primary functions. The following are the secondary functions of money:

1. Standard of deferred payments : Money serves as a standard of deferred payment. *Deferred payments refer to those payments which are to be made in future.* In a modern economy, a large number of transactions involve future payments which can easily be stated in terms of money. Suppose you borrow a sum of ₹ 20,000 at 10 per cent interest per annum for one year. It means that you promise to pay ₹ 22,000 (₹ 20,000 as principal and ₹ 2000 as interest) after one year. Money serves as a standard of such future payments.

Importance : This function of money has two advantages :

(i) It facilitates the borrowing and lending activities.

(ii) Financial institutions are the backbone of modern business. Money has led to the creation of these financial institutions. There would have been no financial institutions, like banks, finance companies, etc. in the absence of money.



2. Store of value : *Store of value means store of wealth for use in future i.e., shifting of purchasing power from the present to future.* Money is not perishable and its storage costs are also considerably lower. It is acceptable to anyone at any point of time. It, thus, enables the people to save a part of other current income and store it for future use. Thus the money provides the link between the present and the future. Store of value function of money is also called asset function of money.

Importance : It was very difficult to store wealth under barter system. Now it has become most convenient to store wealth in terms of money. It is because

(i) money can be easily exchanged for goods at all times

(ii) money comes in convenient denominations. For example, in India, we have one rupee, two rupee, five rupee and ten rupee coins and currency notes ranging from one rupee to one thousand rupees, and

(iii) money is easily portable.

Drawback of Store of Value Function

However, store of value function of money has also its serious implication. Money which is not spent may cause aggregate demand for goods and services to fall. Fall in AD may reduce the level of output and employment in the economy. Therefore, savings need to be utilised for investment.

The four main functions of money can be summed up in the following couplet :

Money is a matter of functions four
A medium, a measure, a standard, a store

3. Transfer of value : Money also serves as **transfer of value.** It is because of this function of money, people can buy goods at far off places. They can also purchase immovable property at any specific place for money. Further, people can loan out their surplus funds and earn interest income. Money, thus, facilitates buying and selling of goods across all parts of the country and abroad.

Box 5.1 : Contingent Functions

Contingent functions refer to those functions of money which help various economic entities such as consumers, producers etc. in taking their economic decisions. These include the following :

(i) **Distribution of National Income :** Money helps in the distribution of national income among various factors of production in the form of rent, wages, interest and profit. Contribution of the factors of production namely land, labour, capital and enterprise is rewarded not in terms of goods and services they have produced but in terms of money.

(ii) **Maximisation of Utility :** With the help of money, a consumer maximises his satisfaction by equating the price of each commodity with the marginal utility. For equalising this, money plays an important role because prices of all goods are expressed in terms of money.

(iii) **Maximisation of Profit :** A producer can maximise his profit by equating the marginal productivity of a factor to its price.

(iv) **Basis of Credit :** It is money which provides the basis of the entire credit system. Without the existence of money, instruments like cheques, bills of exchange etc. cannot be used.

(v) **Productivity of Capital :** Money is the most liquid asset and can be put to any use. Due to this feature of money, capital can be transferred from less productive uses to more productive uses. It, thus, increases the productivity of capital.

Box 5.2 : Static and Dynamic Functions of Money

Paul Einzig has classified functions of money into *two broad* groups viz.,1. Static functions, and 2. Dynamic functions.

- **Static functions**

Static Functions are those which help the operation of the economy but these do not create movement in the economy. In this respect, the functions of money like medium of exchange, measure of value, store of value and measure of deferred payments are called the static functions of money. Static functions, in fact, are the **traditional functions of money.**

- **Dynamic functions**

The dynamic functions are those which actively influence the economy system through its impact on price level, interest rates, volume of production, etc. Important dynamic functions of money are stated below :

(i) Money influences the general price level which in turn affects (encourages or discourages) production and welfare of the society. Price level increases with the increase in money supply and decreases with the decrease in money supply.

(ii) Money directs idle resources into productive channels. People keep their savings in the form of bank deposits to earn interest income. Banks in turn lend this accumulated money to businessmen for investment. This makes capital mobile.

(iii) Money also has its great impact on economic activity by changing interest rates. As rate of interest falls, the level of investment rises. Interest rate falls with an increase in money supply.

5. Supply of Money

5.1 Meaning of Supply of Money

Supply of money is defined as the total stock of all the forms of money (paper money, coins and demand deposits at banks) which are held by the public on a specific day. The term public implies the people using money in carrying out their transactions. In it government and banking system are not included as they are creators (or producers) of money.

Two Features of Supply of Money

(i) **Stock variable :** Supply of money is a stock variable because it is related to a point of time.

(ii) **Money held by the public :** Supply of money always refers to the stock of money held by the public. The stock of money with government, Reserve Bank of India and banking system is not included in supply of money as it does not come into circulation in the country. Supply of money includes that money which belongs to the public for use to carry out transactions.

5.2 Components of Supply of Money

Money supply is composed of the following two elements:

(a) Currency with the public

(b) Demand deposits at banks

(a) **Currency with the public** : Currency with the public include following items :

(i) Currency notes in circulation issued by the Reserve Bank of India.

(ii) Small coins in circulation.

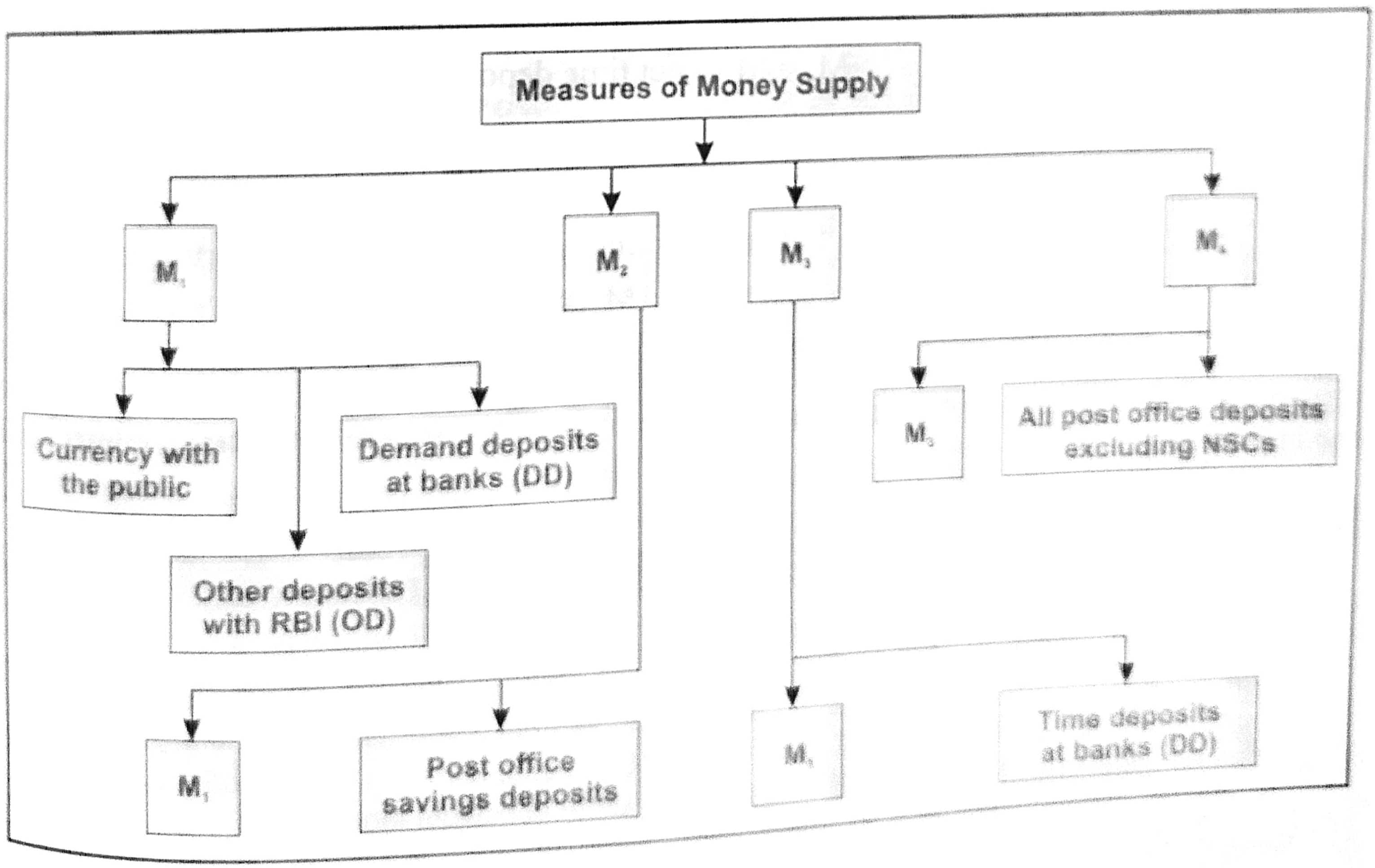
(b) **Demand deposits at banks:** Demand deposits are another important component of money supply. As mentioned earlier, demand deposits with banks are also called **bank money**. Demand deposits in the banks refer to those deposits which are payable on demand. These are the deposits on which cheques can be written. Through cheques these deposits can be transferred to others for making payments from whom goods and services have been purchased. Thus, cheques make these demand deposits as a medium of exchange and therefore, make them to serve as money.

Note that inter-bank deposits do not constitute part of money supply as they do not belong to the public. Only **net demand deposits of commercial banks** are included in money supply. **The word 'net' here implies only the deposits of public held by banks.**

Thus, money supply (M) is composed of currency held by the public (C) and demand deposits with banks (DD).

In short,

$$M = C + DD$$



5.3 Measures of money supply

The Reserve Bank of India has given four measures of money supply viz, M_1, M_2, M_3 and M_4. They are defined as follows:

M_1

$$M_1 = C + DD + OD$$

C is currency held by the public. DD is the demand deposits of people in banks. OD (other deposits) are the demand deposits held by the RBI of Public Financial Institutions (like IDBI), foreign central banks and foreign governments, international financial institutions like IMF. Deposits of government and banks are not included in these other deposits.

M_1 is the most liquid measure of money supply as all its components are easily used as medium of exchange.

M_2

It is a broader concept of money supply compared to M_1. Besides M_1, it also includes saving deposits with post offices.

$$M_2 = M_1 + \text{savings deposits with post offices}$$

M_3

It is a broader concept. Besides M_1, it also includes net time deposits at banks.

$$M_3 = M_1 + \text{net time deposits of commercial banks}$$

M_4

Besides M_3, it includes total deposits with post offices.

$M_4 = M_3$ + total deposits with post offices (excluding National Savings Certificates).

M_1 and M_2 are called **narrow money** while M_3 and M_4 are called **broad money**. This classification is based on the quality of liquidity. Among all the four measures, M_1 is the most liquid while M_4 is the least liquid. By liquidity we mean the conversion of an asset into cash easily and quickly without loss of value. **M_3 measure of money supply is known as aggregate monetary resources of the country.**

1. Narrow Money (M1)

👉 The most **liquid forms of money** – meaning they can be used for transactions immediately.

It usually includes:

- **Currency in circulation** (notes + coins with the public)
- **Demand deposits** with banks (current + savings accounts that can be withdrawn anytime)
- **Other deposits with the central bank** (from government/public bodies, if included in a country's definition)

✅ **Key point**: Narrow money = money you can spend right now.

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2. Broad Money (M3)

👉 A **wider measure** of money supply. It includes **M1 plus less liquid forms** of money.

It usually includes:

- **M1 (narrow money)**
- **Time deposits with banks** (fixed deposits, recurring deposits, term deposits)

✅ **Key point**: Broad money = M1 + money kept in the bank for longer periods (less liquid, but still part of money supply).

Contents

People keep their surplus money in banks. Out of this money, banks give loans to the needy. Thus, banks are important and essential institutions in any modern society. They act as intermediaries between savers and borrowers. In this chapter, we shall discuss the process of money creation by commercial banks.

There exists a supreme institution which is called central bank. It issues currency, acts as banker of the government and of other banks, and controls supply of money and credit to maintain economic stability in the country. We shall also describe the main functions of a central bank.

1. Commercial Banks

1.1 Meaning of Commercial Bank

A commercial bank is a financial institution which accepts deposits from the public and gives loans for purposes of consumption and investment.

"A Banking Company is one which transacts the business of banking which means the accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft or otherwise."

Banking Companies Act 1949

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There are *two* essential functions that a financial institution must perform to become a commercial bank. These are:

(a) Acceptance of demand deposits that have cheque facilities.

(b) Lending

Acceptance of chequable deposits is necessary, but not sufficient condition for a financial institution to become a commercial bank. For example, post-office savings banks are not banks even though they accept chequable deposits from the public. This is because they do not perform the function of lending. In other words, they do not create demand deposits which are a part of money supply. Similarly, lending alone does not make any financial institution a bank. For example, many financial institutions like Life Insurance Corporation of India, Unit Trust of India, etc., give loan but they do not accept chequable deposits from the public. These financial institutions also do not create money and hence cannot be called banks.

1.2 Functions of Commercial Banks

Accepting deposits and lending money are the two primary functions of commercial banks.

(1) Accepting deposits

The primary function of every commercial bank is to accept deposits from the public. They accept deposits from the public. To attract savings, the banks accept mainly three types of deposits:

(a) demand deposits

(b) fixed deposits, and

(c) saving deposits

(a) **Demand deposits :** *Demand deposits (also known as current account deposits) are those deposits which are repayable by banks on demand.* These are chequable deposits. These can be withdrawn by any number of times. No interest is paid on such deposits. These deposits are made by businessmen to carry out their day to day transactions.

(b) **Fixed deposits (or Time deposits) :** *Fixed deposits are those deposits which can be withdrawn only after the expiry of certain fixed period, say a few months or a few years.* Fixed deposits are maintained both by firms and households. The rate of interest offered on such deposits depends on the time period. **The longer the period, the higher will be the interest rate.** No cheque facility is available on these deposits.

(c) **Saving account deposits :** Saving account deposits have the features of both demand deposits and saving deposits. Cheque facility is provided to the depositors. But some restrictions are imposed on number and amount of withdrawals. Hence, banks offer interest on these accounts but less than that on fixed deposits.

It should be noted that current deposits and some proportion of saving deposits are called chequable deposits (or demand deposits) whereas fixed deposits are non-chequable.

Demand deposits can be distinguished from time deposits as under :

Basis	Demand Deposits	Time Deposits
1. **Payable**	They are payable on demand.	These are deposits for a fixed period of time.

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2. Interest on deposits	No interest is given on these deposits.	High rate of interest is given on such deposits.
3. Restrictions on withdrawal	There is no restriction on their withdrawals and deposits.	There are restrictions on their withdrawals. Money is paid on maturity.
4. Cheque Facility	They can be withdrawn by cheques.	They are not chequable deposits.
5. Medium of Exchange	They are used as medium of exchange.	They can not be used as medium of exchange.

(2) Advancing loans

Giving loans is another primary function of the commercial banks. They advance loans and earn interest income. Banks give loans mostly for productive purposes against collateral securities. The amount of loan is generally less than the value of the security offered. Banks advance following types of loans:

(a) **Cash credit :** Under this loan, a credit limit is sanctioned by the bank. The borrower may withdraw any amount within this sanctioned limit. The borrower is charged interest only on the amount of money that has been actually drawn and not on the amount that has been sanctioned.

(b) **Demand loans :** Demand loans refer to those loans which can be recalled on demand by the bank at any time. The entire sum of demand loan is credited to the borrower's account and interest is payable on the entire amount.

(c) **Short term loans :** They are given as personal loans against some collateral security. The money is credited to the account of borrower and the borrower can withdraw money from his account and interest is payable on the entire amount of loan granted.

1.3 Money (or Credit) Creation by Commercial Banks

Money creation is one of the most important functions of commercial banks. Commercial banks are an important source of money supply in an economy. They add to money supply by creating demand deposits. Money creation is the process of expansion of credit through derivative deposits. It is also known as 'Deposit creation' and 'Credit creation'.

Money creation by banks is determined by :

(i) The amount of initial deposits or primary deposits

(ii) The Legal Reserve Ratio (LRR)
LRR is the minimum ratio of deposits legally required by the commercial bank to be kept as cash.

Process of money (credit) creation

The process of money creation by banks can be illustrated with the help of an example. Suppose that all banks receive initial cash deposits of ₹ 1,000 and LRR is 10%. It means banks are required to keep only 10% of deposits (i.e., ₹ 100) and lend the remaining amount of ₹ 900. Banks do not give loans in cash rather open an account in the borrower's name and deposit the loan amount in his account. The borrower is free to withdraw the amount as and when they wish.

This kind of deposit is called **secondary deposit or derivative deposit**. Derivative deposit is the creation of loan. Suppose, borrowers withdraw the entire amount of loan and spend it for making payments of goods and services received. The sellers of these goods and services receive ₹ 900 as revenue and deposit the same in their respective banks. It will increase the demand deposits of banks by ₹ 900. They keep 10% of these new deposits i.e.,₹ 90 as cash reserve and lend the remaining amount of ₹ 810. The borrowers will again use their loans for making payments which again comes back into the accounts of those who have received these payments. Banks again will keep 10% of ₹ 810 and lend the remaining amount of ₹ 729 (810 - 81). Like this in each successive round creation of deposits will be 90% of previous round. In each round, increase in deposits becomes smaller and smaller till it becomes almost zero. The total deposits will ultimately be of ₹ 10,000 which is 10 times the initial deposits of ₹ 1,000. The working of the process of money creation has been shown in the following table :

Process of Money (credit) Creation

Round	Deposits (₹)	Cash Reserves (LRR = 10%) (₹)	Loans (₹)
Initial Deposits	1000	100	900
First Round	900	90	810
Second Round	810	81	729
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Total	10,000	1,000	9,000

From the example, we observe that the initial cash deposits were just ₹ 1000. Banks are able to create total deposits of 10,000 which are 10 times of the initial deposits. Ten times is nothing but the value of money multiplier. The supply of money in the economy is increased by ₹ 10,000 in form of demand deposits.

$$\text{Money (or credit) Multiplier} = \frac{1}{LRR} = \frac{1}{.10} = 10$$

$$\text{Total demand deposits} = \text{Money Multiplier} \times \text{Cash Reserves}$$

$$= 10 \times 1000 = ₹\ 10{,}000$$

Here, LRR refers to the cash reserves of banks.

Assumptions

The process of credit creation is based on the following two assumptions.

(i) All the depositors do not approach the banks for withdrawal of cash at the same time and also they do not withdraw their entire amount.

(ii) All receipts and payments in the economy are made through banks. In other words, all receipts are deposited in banks and all payments are made through cheques .

...tation

...ing are the important limitations on the part of commercial bank to create credi...

(i) **Amount of cash :** Commercial banks create credit on the basis of total amount of cash in the country. Hence, there should be the larger availability of cash. But the amount of cash that a bank may have is subject to control by central bank.

(ii) **Currency deposit ratio :** The creation of credit by commercial banks also depends upon the ratio of currency held by public to their holdings of bank deposits $\left(\frac{C}{DD}\right)$. This is called currency deposit ratio (CDR). Higher the CDR lower will be the power of banks to create credit.

(iii) **Legal reserve ratio :** Another important limitation is the legal reserve ratio. As the credit potential is inversely related to the reserve ratio, the higher the legal reserve ratio, the lower will be the proportion of excess funds and lesser is the quantum of money (credit) creation.

2. Central Bank

2.1 Meaning of Central Bank

Central bank is an apex (supreme) institution in the banking and financial structure of a country. It is the leader of the money market. It supervises, regulates and controls the whole banking and financial system. It is called central bank because it occupies a central position in the monetary and banking structure of the country.

"Central bank is an apex bank of the monetary and banking structure of a country. It controls the supply of money and credit in the country".

Almost all the countries in the world have their central banks. Reserve Bank of India is the central bank of India which was established on April 1, 1935. The Bank of England was the first to function as a central bank in 1844. Federal Reserve System operates as the Central Bank of USA.

2.2 Distinction Between a Central Bank and Commercial Banks

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

Basis	Central Bank	Commercial Banks
1. Nature	Central bank is a supreme institution of the monetary and banking structure of the country.	Commercial banks deal in money and credit for the purpose of earning profit.
2. Object	It acts in the public interest.	Their main objective is to earn profits.
3. Note-Issue	It has sole monopoly over note-issue.	Commercial banks have no legal power to issue notes.

4. Ownership	It is generally a government owned institution.	Commercial banks may operate both in private as well as public sectors.
5. Number	There is only one central bank in a country.	There are a number of commercial banks in every country.
6. Banker	It is a banker of the government. It is also the banker of the commercial banks. It does not directly deal with the public.	Commercial banks directly deal with the public.

2.3 Functions of a Central Bank

A central bank performs a number of important functions in every economy. The major functions of a central bank are discussed below :

1. **Issue of currency :** The central bank enjoys the sole legal right to issue currency notes. The currency so created is called **'high powered money'.** That is why it is called **'Bank of Issue'**. These notes circulate throughout the country as legal tender money. Like any other central bank, the RBI has the sole right to issue currency notes.

Following are the main reasons for giving the monopoly right of note-issue to the central bank.

(i) It brings about uniformity in note circulation.

(ii) It is easier to control credit when there is a single agency of note issue.

(iii) It keeps the public faith in the paper currency.

(iv) It helps in the stabilisation of the internal and external value of the currency.

2. **Banker, Agent and Advisor to the Government** : Central bank everywhere in the world acts as banker, agent and advisor to the government.

(a) **Banker**

- As a banker to the government, it manages the banking accounts of government departments.
- It performs the same banking functions for the government as commercial bank performs for its customers. It accepts deposits and makes payment for the government.
- It also gives short period loans to the government.

(b) **Agent**

- As an agent to the government, it buys and sells securities, treasury bills on behalf of the government.
- It also manages public debt.

(c) **Advisor**

- Central bank gives advice to the government on economic and financial matters such as deficit financing, devaluation of currency, foreign trade policy, foreign exchange policy etc.

3. **Banker to the Banks :** The central bank has the same relationship with the commercial banks as the latter has with the general public.

(i) Commercial banks are required to keep a part of their deposits with the central bank in the form of cash. The central bank is the **custodian of the cash reserves of the commercial banks.**

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(ii) The central bank uses these reserves to meet the cash requirements of individual commercial banks.

(iii) The central bank supervises, regulates and controls the commercial banks. The supervision of banks may be related to their licensing, branch expansion, management, amalgamation (merging of banks) and liquidation (the winding up of banks).

4. **Lender of the Last Resort :** The central bank acts as a lender of the last resort. When a commercial bank fails to meet the obligations of its depositors from all its sources, it can finally approach the central bank. The central bank comes to its rescue and gives loans as lender of the last resort. Central bank gives loans to these banks against the approved securities and bills of exchange. However, commercial banks are supposed to approach other sources first like the call money market and should then only approach the Central bank. That is why, central bank is called the lender of the last resort.

5. **Clearing House Function :** 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 simply by book entries of transfers from and to their accounts. This method of settling accounts is called clearing house function of the central bank. The significance of this function is that it economises the use of money in the banking operations.

6. **Custodian of Nation's Foreign Exchange Reserves :** Central bank is the custodian of nation's foreign exchange reserves. The central bank maintains foreign exchange reserves in order to promote international trade and stabilise exchange rate.

What is “Custodian”?

👉 A **custodian** means a **guardian or keeper** — someone who is responsible for looking after and managing something valuable on behalf of others.

So, when we say:

- Central bank is the **custodian of cash reserves** → it keeps the reserves of all banks safely.
- Central bank is the **custodian of foreign exchange reserves** → it keeps and manages the nation’s foreign currencies and gold.

bank raises its bank rate. It will increase the cost of borrowing by banks. An increase in the bank rate will then cause the banks to raise the rates of interest at which they lend. This will discourage businessmen and others to borrow from them, leading to reduction in the volume of credit and money supply.

Decrease in Bank Rate

During deflation (i.e., a state of falling of prices), central bank reduces the bank rate. Borrowing from the central bank by commercial banks becomes cheaper. Commercial banks also reduce their lending rates. Businessmen are encouraged to borrow more leading to expansion of credit and hence money supply. Output, employment, income and aggregate demand start rising.

Box 6.1 : Bank Rate, Repo Rate and Reverse Repo Rate

Bank Rate

Bank rate refers to the rate of interest at which country's central bank lends money to member banks for a long period as a lender of the last resort.

Repo rate

Repo rate (short form of re-purchase option) refers to the market rate of interest at which central bank lends money to banks for short period. Commercial banks get loans from central bank by selling securities to the latter. However, this is a conditional loan. The condition is that banks will repurchase their securities after a fixed time period at a pre-determined price. There is no such condition in case of bank rate. **The RBI has replaced bank rate with repo rate to influence the availability of credit and rate of interest in the country**.

Reverse Repo Rate

Reverse repo rate is the rate of interest at which the RBI borrows from commercial banks for short period. This is done by selling government bonds to banks. The banks utilise the reverse repo rate facility to deposit their short term excess funds with the RBI and earn interest on it.

(b) Open market operations : *Open market operations (OMO) refer to the buying and selling of government securities (like National Saving Certificates (NSCs)) by the central bank from/to the public and banks.* OMO are used to influence money supply in the country. It does not matter whether the securities are bought and sold to the public or banks, money ultimately is deposited in or transferred from the banks. Suppose people buy securities, they will withdraw their money from the banks. And when they sell the government securities the money so obtained is deposited in banks.

Sale of Securities

During the period of excess demand or inflation, the central bank starts selling government securities in the market. As a result, the cash resources of commercial banks are reduced and they are not in position to lend more to the businessmen. This reduces the volume of credit and money supply in the economy. The level of aggregate demand starts falling.

Purchase of Securities

During deficient demand or deflation, the central bank starts purchasing securities from statutory liquidity ratio.

(i) Cash reserve ratio (CRR): It refers to the minimum percentage of total demand and time deposits to be kept by commercial banks with the central bank. A change in CRR affects the power of commercial banks to create the credit.

Increase in CRR

An increase in CRR reduces the excess reserves of commercial banks and limits their lending power. In other words, the reserves of commercial banks are reduced and they give less credit. CRR is raised during excess demand or inflation. The volume of aggregate demand will decrease.

Decrease in CRR

During the period of deflation (or deficient demand) the central bank decreases the cash reserve ratio. A decrease in CRR has the effect of increasing the banks excess reserves and thus increases their lending ability. Banks now give more credit. Thus when credit or money supply is to be expanded, CRR is reduced.

(ii) Statutory liquidity ratio (SLR) : SLR is another component of legal reserve requirements. It refers to the minimum percentage of net demand and time deposits which commercial banks are required to maintain with themselves. SLR is maintained in the form of cash or other liquid assets. Change in SLR affects the availability of credit.

Increase in SLR

The central bank increases the SLR during the period of excess demand (or inflation). An increase in the SLR, reduces the amount of excess reserves of the banks. This reduces their lending ability to give credit. As a result, the bank lend less. Thus, the volume of aggregate demand will decrease.

Decrease in SLR

The central bank reduces the SLR during the period of deflation when the level of aggregate demand is low. A decrease in the SLR, increases excess reserves of the banks and thus increase their ability to give credit. In other words, the reserves of commercial banks are raised and they give more credit.

2. Qualitative Methods

These methods direct or restrict the flow of credit to specific areas of economic activities, that is, who should get more credit or who should get less credit. These methods are also called **selective methods** which include the following :

(a) Regulation of consumer's credit : Under this method, the credit given to durable consumer goods is controlled. Durable consumer goods (like motor cars, houses, computers etc.) are purchased under *'Hire Purchase System'* and payment is made in given by a commercial bank.

(ii) the central bank may fix the maximum ratio of loans and advances of a commercial bank to its total deposits.

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(d) Moral suasion : Under this method, the central bank adopts the policy of persuasion and pressure on the commercial banks in order to get them to fall in line with its policy. The central bank frequently announces its policy and urges the commercial banks to adopt it. This is exercised through letters, discussions and directives to the banks. The member banks generally do not ignore the advice of the central bank.

Ques What are the different types of Exchange Rate? Explain it.

Ans There are Various Concept of Rate of Exchange System. Two broad Concept are fixed exchange Rate and flexible exchange rate as explained below. In between those two extreme rates, there are some hybrid system like Managed Floating etc. which are briefly discussed in the following manner.

(A) FIXED EXCHANGE RATE SYSTEM: The System of Exchange rate in which exchange rate is Officialy fixed or pegged in term of good or any other currency by the govt. is called fined exchonge rate System.

ADVANTAGES:

1. It Contributes to the Co-ordination of new policies of Countries in an ~~winder~~ interdependent world economy.

2. Fixed exchange rate ensure that major economic distribution in the member Countries do not Occur.

③ Fixed exchange rate are more Conducive to expansion of world trade because it prevent risk and uncertainity in transactions.

This System has many drawbacks which were witnessed during its operation. Therefore, many Critics have suggested and alternative system of flexible exchange rate.

B FLEXIBLE (FLOATING) EXCHANGE RATE SYSTEM: The System of exchange rate in which value of Currency is allow to Adjust freely as determined by demand for and Supply of foreign exchange.

ADVANTAGES:

1. flexible exchange rate eliminate the need for Central banks to hold international reserves.

2. Such rates are helpful in removing the barries to trade and Capital movements.

C Managed Floating :- This system is a hybrid of fixed exchange rate and flexible exchange rate. Under this system, central bank intervenes in the foreign exchange market to restrict the fluctuations in the exchange rate which contains limits. The exchange rate is determined by the market forces.

Ques. What are the Sources of demand for foreign Exchange?

Ans. Payment in foreign Exchange Cause demand for foreign exchange. The following factor cause demand for foreign exchange

SOURCE OF DEMAND FOR FOREIGN EXCHANGE

(I) To purchase goods and Services from foreign Countries.

(II) To purchase financial assets (i.e. to invest in Bonds and equity Shares) in a foreign Country.

(III) To invest directly in shops, factory building in foreign Country.

(IV) To Speculated on the Value of foreign Currencies.

(V) To Spend gift abroad.

(VI) To Undertake foreign tours and Remittance to their families by foreign, working, Say in India.

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Ques What are the Sources of Supply for foreign Exchange?

Ans Reciept in foreign Exchange result in Supply of foreign Exchange. The following factor may cause Supply of foreign Exchange, As a result, foreign Currency flow into domestic economy.

SOURCES OF SUPPLY OF FOREIGN EXCHANGE

(A) When foreigner purchase home Country Goods and services through export (By India)

(B) When foreigner invest in bounds and equity Shares of the home Countries.

(C) When Currency dealers and Speculators Cause flow of foreign Currency in the domestic Economy.

(D) When Indian Worker working Abroad Send three Saving to families in india.

(E) When Foreign tourists Come to India.

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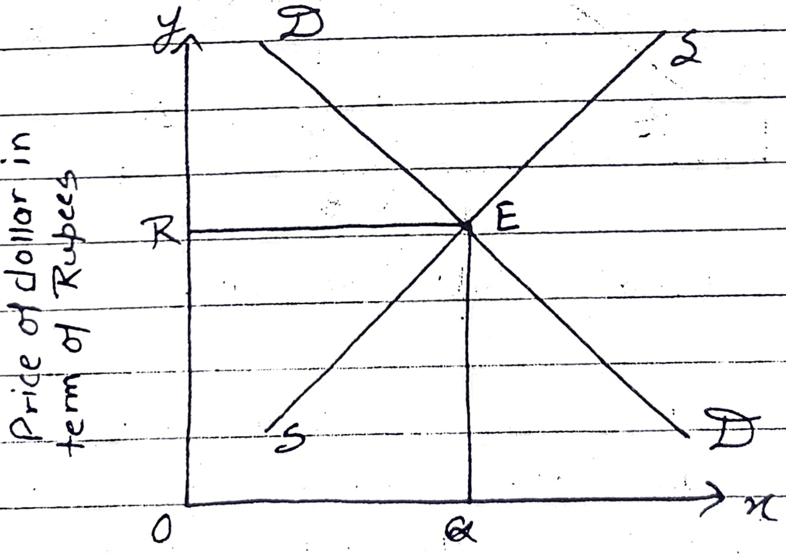
Ques How foreign Exchange Rate is determined ? Explain with the help of diagrams.

Ans In the freely fluctuating exchange market. The exchange rate of a Currency like ~~pride~~ price of a Commodity is determined by demand and Supply of foreign Exchange, in the Foreign Exchange Market. Express Graphically, the intersection of demand and the Supply Curve determined the equilibrium exchange rate and equilibrium quantity of foreign Currency.

Equilibrium Exchange Rate : It is determined at a point where demand for and Supply of foreign Exchange are equal.

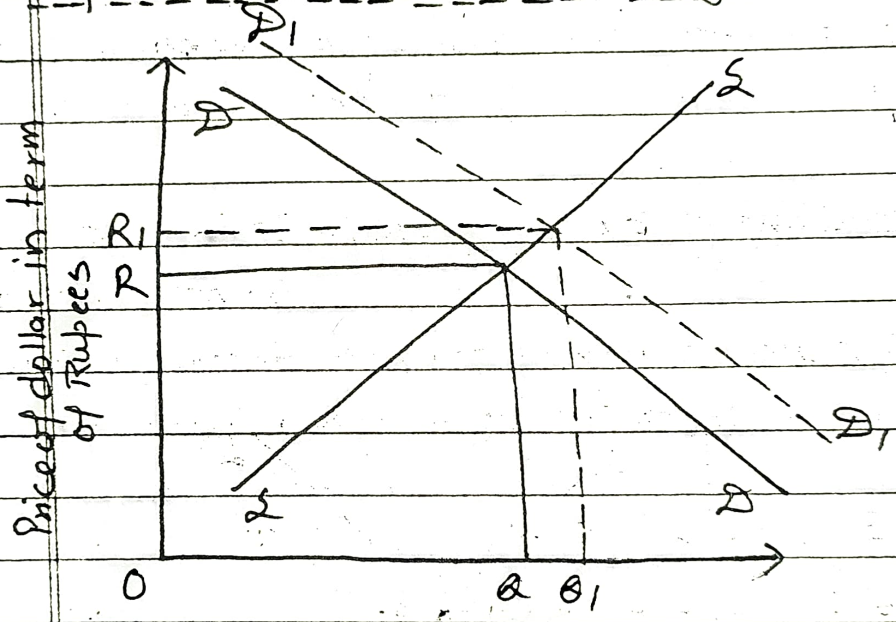


Demand & Supply of dollar

In the Above diagram, demand Curve and Supply Curve of dollar intersect each Other at point E which implies that at exchange rate of OR (QE) quantity demanded and supplied are equal (both are equal to OQ) Hence equilibrium rate ~~of~~ is OR and equilibrium quantity is OQ.

Change in Exchange Rate

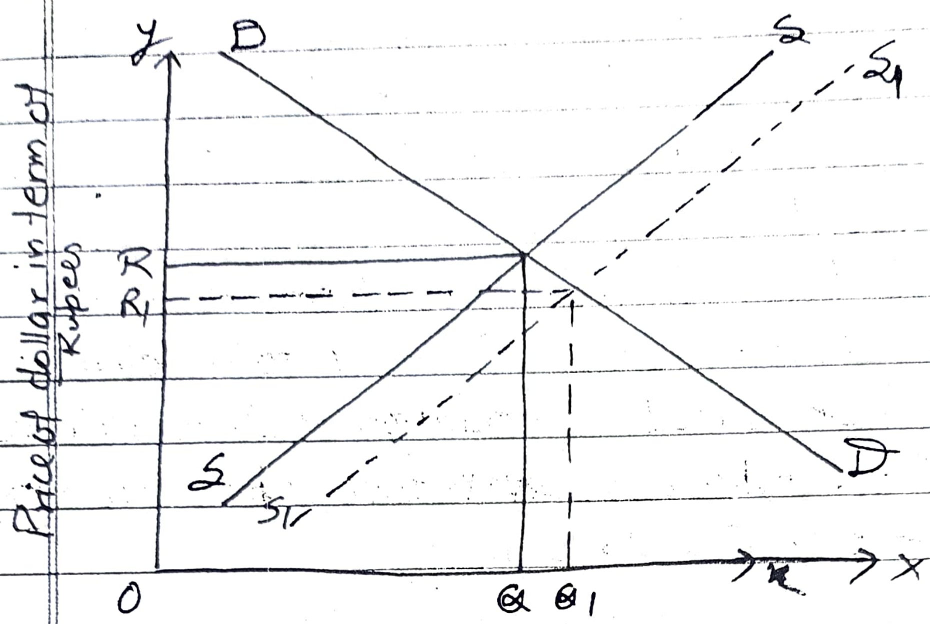
If Increase in India demand for US dollar:



Demand & Supply of Dollar

An Increase in India demand for US dollar will Cause the demand Curve DD to Shift to D_1D_1. As a result, exchange rate will rise from OR to OR_1. It show depreciation of Indian Currency because more money are required to buy one US dollar.

If Increase in India Supply for US dollar



Demand & Supply for US dollar

An Increase in Supply of US dollar will Cause Supply Curve SS to Shift to S_1S_1. As a result exchange rate will fall from OR to OR_1. It Indicates appreciation of Indian Currency because Cost of US dollor in term of Supply has how fallen that means less rupee are required to buy One US dollar.

Depreciation of Money (Currency Depreciation)

👉 Depreciation of money means a **fall in the value of a country's currency** in terms of foreign currencies **under a floating exchange rate system**.

- It happens due to **market forces** (demand and supply of currency).
- Example: If earlier **1 USD = ₹80**, but now **1 USD = ₹85**, then the **rupee has depreciated** (you now need more rupees to buy the same 1 dollar).

Causes of Currency Depreciation

- High imports and low exports (trade deficit).
- Inflation in the domestic economy.
- High demand for foreign currency.
- Capital outflow (investors pulling money out).

Opposite of Depreciation = Appreciation of Money (Currency Appreciation)

👉 Appreciation means an **increase in the value of a currency** against foreign currencies.

- Example: If earlier **1 USD = ₹80**, but now **1 USD = ₹75**, then the **rupee has appreciated** (you need fewer rupees to buy a dollar).

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Appreciation of a Currency : It is increase in its Value in term of another foreign Currency. Thus Currency Appreciation take place when there is a decrease in the domestic Currency price of foreign Currency. for Instance if the Value of a rupee in term of US dollar increases from Rs. 50 to 49 to a dollar. it will be Called Appreciation of Indian Currency (i.e. rupee) because less rupee are required to buy One US dollar.

Depreciation of a Currency : It is the fall in its Value in term of another foreign Currency. Thus Currency Appreciation take place when there is an increase in the domestic Currency price of the foreign Currency. for Instance, if the Value of rupee in term of US dollar fall Say from Rs. 50 to 51 to a dollar it will be a Case of depreciation of ~~Money~~ Indian rupee because more rupee are required more to buy One US dollar.

- **Foreign exchange :** All currencies other than the domestic currency of a given country are called foreign exchange.

- **Foreign Exchange Rate :** It is the rate at which one currency is exchanged for the other. It measures the number of units of one currency required to exchange with one unit of another.

- **Currency Appreciation and Currency Depreciation :** Currency appreciation means rise in the price of domestic currency in terms of foreign currency. The domestic currency becomes more valuable and less of it is required to buy per unit of foreign currency.

  A fall in the price of domestic currency in terms of foreign currency is called currency depreciation. The domestic currency becomes cheaper and more of it is required to buy a unit of foreign currency.

- **Devaluation and Revaluation :** Devaluation means reduction in the external value of domestic currency by the government. And revaluation denotes an increase in the external value of domestic currency by the government.

- **Types of Foreign Exchange Rate :**

  Three main types of exchange rate systems are :

4. Foreign Exchange Market

4.1 Meaning

Foreign exchange market refers to the market in which national currencies are traded for one another. The major participants in this market are commercial banks, foreign exchange brokers and other authorized dealers and the monetary authorities.

4.2 Functions

Foreign exchange market performs mainly the following three functions :

(i) **Transfer function :** It transfers purchasing power between the countries involved in the transaction. This function is called transfer function.

(ii) **Credit function :** It provides credit for foreign trade. Bills of exchange with maturity period of three months, are generally used for international payments. Credit is required for this period in order to enable the importers to take delivery of goods, sell them and obtain money to pay off the bill. This function is called credit function.

(iii) **Hedging function :** When exporters and importers enter into an agreement to sell and buy goods on some future date at an exchange rate agreed upon today, it is called hedging.

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BALANCE OF PAYMENT

A balance of Payment account is a statement of double entry system of all economic transaction (involving foreign Payment) between resident of a Country and the rest of the world Caried out in specified period. It is a Summary of international transaction of a Country for a given period (i.e. financial year)

These monetary transaction arise due to:

(I) Transaction in good, also known as merchandise or visible item.

(II) Transaction in services also known as in-visible items.

(III) Transaction in Capital, Like loans, deposits, investment etc.

These transaction are settled in foreign exchange more generally in a hard Currency like dollar.

Inflow of foriegn exchange Constitute the Credit Side of the accounts. Outflow of foriegn exchange Constitute the debit Side of the accounts.

Components of Balance of Payment

Balance of Payment is divided into two parts:-

1. Balanced of Payment on Current A/c
2. Balanced of Payment on Capital A/c

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Balanced of Payment on Current A/c

The Current A/c records inflows and Outflow of foriegn exchange resulting from flow of transfer. Current A/c deals with Payments for Customer Currently produced goods & services. So, it records Sources (Credit) and Uses (debit) of foriegn exchange on accounts of flow of goods, Services and transfer income.

Main Item or Components of Current A/c of BOP are as follows:

① Export & Import of Goods : The Straight forwards way in which Country Can acquire foriegn exchange Currently is by exporting goods.

These are Called visible items. movement of goods between Countries is Known as visible trade because the movement is open and Can be verified by Custom officials.

② Export & Import of Services : Under this head services like Shiping, banking, insurance, tourism etc are export & Import from one to another Country. These are Called visible Items.

(3) Unrequited or Unilaterads transfers: They Called

because resident of a Country recieve for free. Nothing has to paid in return at present or future for these reciepts. These are Like transfer payments. It ~~indudes~~ include both private and govt. transfers. Example of- gifts, recieved by residense from for given remitance sent by amigrance to relative, war indemnities paid by deafeated Country.

Balance of Payments on Capital A/c

The Capital account reflects all inflow and Outflow of foriegn exchange resulting from transaction leading to change in foreign financial assets and foreign financial Liabilities.

Various forms (items) of Capital A/c :-

(1) Private transaction : These are those which affects assets & Liab. by Industries, business and Other non govt. entities. the bulk (large Quantities) of foriegn investment is private.

Liabilities by goverment and its agency.

③ Direct Investment: It means purchasing on assets at the same time acquiring Control of it e.g. acquisation of a firm in one Country by a firm in on other Country or purchase of a house by Ind. abroad.

④ Port folio lio of Investment: It is the acquisation of on assets that does not give the purchase Controlt over assets. Investment in Share and debentures.

1. Current Account

👉 Deals with **day-to-day transactions of goods, services, income, and transfers.**
It shows whether a country is earning more from the world or spending more.

Components:

1. **Trade in Goods (Merchandise Trade)**
   - Exports (credit/earning) and Imports (debit/spending) of physical goods.
   - Example: India exports software, imports crude oil.
2. **Trade in Services (Invisibles)**
   - Exports and imports of services like banking, insurance, transport, tourism, IT.
   - Example: India earns from IT services, spends on shipping/insurance.
3. **Income**
   - Earnings from investment (interest, dividends, profits).
   - Example: An Indian invests in US bonds and earns interest.
4. **Current Transfers**
   - One-way transfers with no quid pro quo.
   - Example: Remittances by Indians working abroad, gifts, grants, donations.

2. Capital Account

👉 Deals with **financial transactions that change assets or liabilities of a country** with the rest of the world.
It shows the movement of **capital (money for investment/loans)**, not regular trade.

Components:

1. **Foreign Direct Investment (FDI)**
   - Foreign companies setting up factories or buying stakes in Indian companies.
2. **Foreign Portfolio Investment (FPI)**
   - Foreigners buying shares, bonds, etc., in Indian stock markets.
3. **External Commercial Borrowings (ECBs)**
   - Loans taken by Indian companies/government from abroad.
4. **Banking Capital & Reserves**
   - Changes in foreign exchange reserves of RBI.

Tax and Subsidy

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TAX

Tax is compulsory contribution by citizens of a country to the government exchequer. For example, income tax, sales tax, etc. Tax is different from fees paid by citizens of a country on the services provided by government. As discussed in the previous section, the amount of money collected through tax may not be spent by the government on the same group of persons. In fact, tax paid and the services which are provided by the government from the money collected as tax are used by different segments of the society. Generally, tax is paid by rich persons and government facilities as government schools and hospitals are used by the poor. However, fee is paid by the same person who uses the services and the amount of fee is in direct proportion to the volume of services or goods used.
Taxation should be certain, timely and economical to collect. Government spends money on the establishment through which tax is collected. If it is not economical, the state will not be benefited from the collection of taxation.

Types of taxes

Taxes can be classified on the basis of following criteria.
On the basis of rate of taxation

There are two types of taxes on the basis of rate of taxation: proportional tax and progressive tax. In proportional tax, rate of tax remain same irrespective of size of income. However, in case of progressive tax, on the other hand, rate of tax increases with increase in size of the income, i.e., higher the income, higher will be the rate of tax. Income tax is example in India, which is based on the marginal utility of unit money which is less for rich people and more for poor people. So rich people should pay more money as tax than the poor so that ratio of sacrifice to income will be same for all. It can be expressed as follows:

<-This is on basis of rate of taxation

1. Based on Burden of Tax

(a) Direct Tax

- Tax is paid **directly by the person on whom it is imposed**.
- Burden **cannot be shifted**.
- Example: **Income Tax** – if you earn income, you yourself pay the tax.

(b) Indirect Tax

- Tax is imposed on one person but the **burden is shifted to others**.
- Example: **Sales Tax / GST**
  - Government charges sales tax on producer → producer passes it to distributor → distributor passes it to retailer → retailer includes it in the price → **customer finally pays**.

👉 Who bears how much of the burden depends on **price elasticity of demand and supply (ed & es):**

- **If demand is more elastic than supply (ed > es)** → consumers bear **less burden**, producers bear more.
- **If demand is less elastic than supply (ed < es)** → consumers bear **more burden**, producers bear less.

1. Direct Tax

- A tax that is **directly paid by individuals or organizations to the government**.
- The burden of tax **cannot be shifted** to someone else.
- Example:
  - **Income Tax** (you pay directly on your income).
  - **Corporation Tax** (companies pay on their profits).
  - **Wealth Tax / Property Tax**.

Key Features of Direct Tax

- Levied on **income and wealth**.
- Paid **directly by the taxpayer**.
- Tax burden **cannot be transferred**.
- Progressive in nature (rich pay more, poor pay less).

2. Indirect Tax

- A tax that is **levied on goods and services**, and collected by intermediaries (like shopkeepers, service providers) on behalf of the government.
- The burden of tax **can be shifted** from one person to another.
- Example:
  - **GST (Goods and Services Tax)**.
  - **Customs Duty** (on imports/exports).
  - **Excise Duty** (on manufacturing).

Key Features of Indirect Tax

- Levied on **expenditure (goods/services)**.
- Collected by sellers/producers, but **paid by consumers**.
- Tax burden **can be shifted** (producer → consumer).
- Regressive in nature (same rate for rich and poor, so burden falls more on poor).

2. Value Added Tax (VAT)

- A **type of sales tax** but more systematic.
- Imposed on **value added** at each stage of production and distribution (manufacturer → wholesaler → retailer).
- Helps avoid **cascading effect** (tax on tax), which was common in old sales tax/excise duty.
- Launched in **India in 2005**, and later replaced by **GST (Goods and Services Tax)** in 2017.

👉 **Benefit**: Simple, transparent, avoids double taxation, and ensures fairness.

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3. Based on Place of Production

- **Excise Duty** → tax on goods produced **within the country**.
- **Customs Duty** → tax on goods **imported** from foreign countries.
  - Sometimes used to make imports more expensive and **protect domestic industries** (trade protection measure).

1. Subsidy

- **Meaning**: A subsidy is **financial support given by the government to an industry** to reduce the cost of production, so that the selling price can be kept lower than the actual cost.
- **Purpose / Reasons for giving subsidy**:
  1. **Help poor people** – e.g., food subsidy so that poor can afford meals.
  2. **Encourage eco-friendly products** – e.g., subsidy on CNG fuel.
  3. **Counter foreign trade policies** – if another country imposes import duty on Indian goods, India may give subsidies to its exporters to remain competitive.

2. Government Control: Fiscal Policy

- **Fiscal Policy** = government policy of **taxation and expenditure (subsidy)** to control the economy.
- **Objective**: control inflation, boost growth, influence demand.
- Examples:
  - **Taxes**: Higher taxes reduce people's purchasing power → control inflation.
  - **Subsidies**: Encourage people to use certain products (e.g., fertilizers for farmers).
  - **Tax rebates**: Government encourages people to invest in LIC/insurance by giving tax deductions.

👉 So, fiscal policy is about using **tax and subsidy** to control demand and improve welfare.

Monetary and Fiscal Policy

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1. Monetary Policy

👉 **Controlled by:** Central Bank (e.g., RBI in India, Federal Reserve in US).

👉 **Meaning:** It is the policy related to **money supply, interest rates, and credit flow** in the economy.

👉 **Objective:** Control inflation, stabilize currency, promote growth, ensure financial stability.

Tools of Monetary Policy

- **Quantitative (General tools)**: affect the overall supply of money.
  - CRR (Cash Reserve Ratio)
  - SLR (Statutory Liquidity Ratio)
  - Repo rate, Reverse Repo rate
  - Open Market Operations (buying/selling govt. securities)
- **Qualitative (Selective tools)**: direct credit to specific sectors.
  - Credit rationing, margin requirements, consumer credit regulation, etc.

✅ Example:

- If inflation is high → RBI increases repo rate and CRR → loans become costlier → money supply decreases.
- If economy is slow → RBI reduces repo rate → loans become cheaper → money supply increases.

2. Fiscal Policy

👉 **Controlled by:** Government (Ministry of Finance).

👉 **Meaning:** It is the policy related to **government's revenue (taxation) and expenditure (spending & subsidies)**.

👉 **Objective:** Control inflation/deflation, reduce unemployment, promote growth, reduce inequalities.

Tools of Fiscal Policy

- **Taxes:** direct tax (income tax, corporate tax) and indirect tax (GST, excise, customs).
- **Expenditure:** subsidies, public spending on infrastructure, welfare schemes.
- **Deficit Financing:** borrowing or printing new money to cover gap between revenue and expenditure.

✅ Example:

- If unemployment is high → govt. spends more on public works, cuts taxes → increases demand → jobs created.
- If inflation is high → govt. reduces spending, increases taxes → demand falls → prices stabilize.

Dumping

Dumping: Meaning

👉 **Dumping** is a practice in international trade where a country or company **exports a product at a price lower than its cost of production** or **below the price it charges in its own domestic market**.

- It is often done to capture a foreign market by undercutting competitors.
- Dumping is generally considered an **unfair trade practice** because it can harm industries in the importing country.

Types of Dumping

1. **Predatory Dumping**
   - Goods are sold very cheaply (even below cost) in a foreign market to eliminate local competitors.
   - Once competition is destroyed, the exporter increases prices.
2. **Persistent Dumping**
   - A country regularly sells goods at lower prices abroad than at home to maintain or increase its market share.
3. **Sporadic Dumping**
   - Occasional sale of surplus goods at very low prices in foreign markets to avoid price fall in domestic markets.
4. **Reverse Dumping**
   - When goods are sold at **higher prices abroad** than at home (rare case, usually due to strong demand abroad).

Reasons for Dumping

- To enter and capture foreign markets.
- To dispose of surplus stock.
- To make use of economies of scale (mass production reduces costs).
- To weaken or destroy foreign competition.

Effects of Dumping

On Importing Country

- **Positive:** Consumers benefit from low prices in the short run.
- **Negative:** Domestic industries may suffer losses → closures → unemployment.

On Exporting Country

- **Positive:** Expands market share abroad.
- **Negative:** May face anti-dumping duties or trade barriers from importing countries.

IPR

Intellectual Property Rights are **legal rights given to creators or inventors** to protect their **intellectual creations** (ideas, inventions, artistic works, brands, designs, etc.).

They ensure that the creator gets recognition or financial benefits from their work and prevent others from using it without permission.

Types of IPR

1. **Copyrights** – for books, music, films, software, etc.
2. **Patents** – for inventions and new technologies.
3. **Trademarks** – for brand names, logos, slogans.
4. **Industrial Designs** – for product designs, shapes, packaging.
5. **Geographical Indications (GI Tags)** – for products linked to a region (e.g., Darjeeling Tea, Banarasi Saree).
6. **Trade Secrets** – confidential business information (e.g., Coca-Cola formula).

Importance of IPR

- Encourages **innovation and creativity**.
- Protects inventors and artists from **copying or misuse**.
- Promotes **economic growth** by rewarding research and development.
- Helps in **global trade** (since unique products/tec...ologies get protection).

WTO

2. WTO (World Trade Organization)

👉 **Meaning:**

The **WTO** is an **international organization** established in **1995**, headquartered in **Geneva, Switzerland**, which deals with the **rules of trade between nations**.

Functions of WTO

1. **Promotes free trade** by reducing trade barriers (like tariffs, quotas).
2. **Settles trade disputes** between countries.
3. **Monitors trade policies** of member nations.
4. **Provides a platform** for trade negotiations.
5. **Ensures fair competition** in international trade.

Relationship between IPR and WTO

- WTO has an agreement called **TRIPS (Trade-Related Aspects of Intellectual Property Rights)**.
- TRIPS sets **minimum standards** for protecting IPR across member countries.
- Example: If India patents a medicine, WTO mem... must respect that patent under TRIPS rules.

Free Trade vs Protection

1. Free Trade

👉 **Meaning:**

Free trade means **international trade without restrictions or barriers** such as tariffs (import taxes), quotas (import limits), or subsidies.

- Goods and services move freely across countries.
- Based on the principle of **comparative advantage** (each country specializes in what it can produce most efficiently).

Advantages of Free Trade

- Consumers get goods at **cheaper prices**.
- More **choices** for consumers.
- Promotes **efficiency and innovation**.
- Encourages **international cooperation and growth**.

Disadvantages of Free Trade

- Domestic industries may suffer from **foreign competition**.
- Can lead to **unemployment** in less competitive sectors.
- Dependence on foreign countries may reduce **economic self-reliance**.

2. Protection (Protectionism)

👉 **Meaning:**

Protection means **government policies that restrict imports** to protect domestic industries from foreign competition.

- Common tools:
  - **Tariffs** (tax on imports).
  - **Quotas** (limit on quantity of imports).
  - **Subsidies** (support to domestic producers).
  - **Import licensing, embargoes** (restrictions or bans).

Advantages of Protection

- Safeguards **domestic industries** (especially new/infant industries).
- Protects **jobs** in home country.
- Reduces **dependence** on foreign goods.
- Can be used for **strategic reasons** (defense, food security).

Disadvantages of Protection

- Consumers pay **higher prices**.
- Less choice for consumers.
- Domestic industries may become **lazy/inefficient** (no competition).
- Can lead to **trade wars** between countries.

Tariffs and Barriers

1. Tariffs (Import/Export Duties)

A **tariff** is basically a **tax on trade**, most commonly on imports.

Why do governments impose tariffs?

1. **Protect Domestic Industries**
   - Imported goods become costlier → people buy more domestic goods.
   - Example: India imposes high tariffs on imported Chinese toys so Indian toy makers can compete.
2. **Generate Revenue**
   - In many developing countries, tariffs are a major source of government income.
3. **Correct Balance of Payments**
   - If imports are very high, tariffs discourage them and reduce trade deficit.
4. **Political/Strategic Reasons**
   - Sometimes tariffs are imposed to put pressure on other countries.
   - Example: US imposed tariffs on Chinese steel to protect US steel industry and counter China.

Types of Tariffs (expanded)

- **Ad Valorem Tariff** → % of value (e.g., 10% of car's price).
- **Specific Tariff** → Fixed per unit (e.g., ₹500 on every mobile imported).
- **Compound Tariff** → Combination of both (e.g., 10% + ₹200 per unit).
- **Protective Tariff** → Mainly to protect domestic industry. <-industry
- **Revenue Tariff** → Mainly to raise money for the government.

2. Barriers (Trade Restrictions)

Barriers are a wider term. They include **tariffs** but also many other methods that make trade difficult.

Why do governments use barriers?

- To **control imports** when they want to protect local jobs/industries.
- To **ensure quality/safety** of goods (e.g., banning unsafe food imports).
- To **save foreign exchange** by reducing unnecessary imports.
- To **support strategic industries** like defense, agriculture, or energy.

Types of Barriers (detailed)

1. **Tariff Barriers** (already explained).
2. **Non-Tariff Barriers (NTBs):**
   - **Import Quotas** → Limit on quantity (e.g., max 1,000 luxury cars per year).
   - **Licensing** → Only licensed importers can bring goods.
   - **Embargoes** → Complete ban on trade (e.g., sanctions on North Korea, Iran).
   - **Subsidies to Domestic Producers** → Govt gives financial support to local industries → their goods become cheaper than foreign imports.
   - **Technical Standards / Health Regulations** → Imported goods must meet certain safety, environmental, or quality norms.
   - **Voluntary Export Restraints (VERs)** → Exporting country voluntarily limits exports to avoid stricter restrictions.

Balance of Trade (BoT)

Balance of Trade (BoT)

- The **difference between the value of a country's exports and imports of goods** during a given period (usually one year).
- It is a **part of the Current Account** in the Balance of Payments (BoP).

Formula:

$$\text{BoT} = \text{Value of Exports of Goods} - \text{Value of Imports of Goods}$$

Types of Balance of Trade

1. **Favourable (Surplus) BoT**
   - When **exports > imports**.
   - Country earns more foreign exchange than it spends.
   - Example: If India exports goods worth $300 billion and imports $250 billion → BoT = +$50 billion.
2. **Unfavourable (Deficit) BoT**
   - When **imports > exports**.
   - Country spends more foreign exchange than it earns.
   - Example: If India exports $300 billion but imports $400 billion → BoT = –$100 billion.
3. **Balanced BoT**
   - When **exports = imports**.
   - Rare in reality, but it's considered an ideal situation.

Balance of Trade vs Balance of Payment

BoT vs BoP

Basis	Balance of Trade (BoT)	Balance of Payments (BoP)
Coverage	Only goods (exports & imports)	Goods + services + transfers + investments
Narrow/Broad	Narrow concept	Broader concept
Indicator	Shows trade surplus/deficit	Shows overall international economic position
Example	India imports more crude oil than it exports goods → BoT deficit	But India earns from IT services & remittances, so BoP may still be stable