Chapter One: Nature and Significance of Money

Definitions of Money:

The functional approach defines money on the principle of its purpose and demand. Hence, the classical definition, “money is anything of value that is generally accepted as a medium of exchange, unit of account and a store of value

“Anything that is generally acceptable as a means of exchange (i.e., as a means of settling debts) and that at the same time, acts as a measure and as a store of value.” — Crowther

This definition covers all the three important functions of money and also stresses its basic characteristic, namely general acceptability.

Functions of Money

1. *Medium of exchange*

It is one of the three fundamental functions of money in mainstream economics. It is a widely accepted token which can be exchanged for goods and services.

2. *Measure of value*

A *unit of account* is a standard numerical monetary unit of measurement of the market value of goods, services, and other transactions. Also known as a "measure" or "standard" of relative worth and deferred payment, a unit of account is a necessary prerequisite for the formulation of commercial agreements that involve debt.

3. *Standard of deferred payment*

In economics standard of deferred payment is a function of money. It is the function of being a widely accepted way to value a debt, thereby allowing goods and services to be acquired now and paid for in the future.

4. *Store of value*

store of value is the function of an asset that can be saved, retrieved and exchanged at a later time, and be predictably useful when retrieved More generally, a store of value is anything that retains purchasing power into the future.

Stages in the Evolution of Money:

(i) Commodity Money:

The second stage in the evolution of money is the introduction of commodity money. Commodity money is that money whose value comes from a commodity, out of which it is made. The commodities that were used as medium of exchange included cowrie shells, bows and arrows, gold, silver, food grains, large stones, decorated belts, cigarettes, copper, etc.

However, the commodity money had various drawbacks such as there could be no standardization of value for money, lacks the property of portability and indivisibility. Therefore this form of money became an unsuitable medium of exchange.

(ii) Coinage:

The next step is coinage. This is just like a commodity money but the commodity is the metal that the money is made of. Thus, it can be seen that commodity money is of two types i.e., metallic and non-metallic.

Metallic money at one stage were used as full bodied money, i.e., the full value was equal to the intrinsic value of the metal.

Non-metallic commodity money was used on a large scale in our early days of civilization.

(iii) Paper Money:

The next important stage in the evolution of money is the paper money which replaced the metallic money. The transfer of sum of money in terms of metallic money was both inconvenient and risky. Therefore, written documents were used as temporary substitutes for money

(iv) Bank Money:

Bank money implies demand deposits with banks which are withdraw able through cheques, drafts, etc. Cheques are widely accepted these days particularly for business transactions. Debit and credit cards also fall under this category.

Characteristics of Money:

1. General Acceptability:

Money is accepted by all as a medium of exchange.

Thus, it has general acceptability. No one denies accepting money as a medium of exchange. People do not hesitate to accept it as standard of payment.

2. Measure of Value:

Value of any good or service can easily be measured in terms of money. It is accepted as a measure of value.

3. Active Agent:

Money is an active agent of an economic system. In modern economy, money is required in every commercial process. Process of production cannot start without the participation of money.

4. Liquid Assets:

Money is highly liquid asset. It can easily be converted in goods and services. Debt, stock and bills, etc., are the other liquid assets but the liquidity of money is highest than the other liquid assets.

5. Money is a Means and not an End:

The word money is means to acquire things desired. Money itself cannot be used to satisfy. It is indirectly used to get any goods or services to satisfy human wants.

6. Voluntary Acceptability:

Money is voluntarily accepted by people. There is no requirement to get legal approval. People always wish to hold money.

7. Government Control:

Reserve Bank of India and Govt, has an authority to issue currency which is accepted as a form of money in India. No other authority can issue currency notes. Thus, the government keeps control over the money supply in the country.

Classification of Money:

Money assumes so many forms in real life that it is difficult to identify what constitutes money and what not. Different economists have classified money in different forms.

The more important classifications of money are as follows:

(i) Money of Account:

Actual money is that which actually circulates in the economy. It is used as a medium of exchange for goods and services in a country. For example, paper notes of different denominations and coins in actual circulation in India constitute the actual money. Money of account is that form of money in terms of which the accounts of a country are maintained and transactions made.

(ii) Commodity Money:

Commodity money is made up of a certain metal and its face value is equal to its intrinsic value. It is also referred to as full-bodied money. Representative money, on the other hand, is generally made either of cheap metals or paper notes.

(iii) Near-Money:

Money is anything that possesses 100 per cent liquidity. Liquidity is the quality of being immediately and always exchangeable in full value for money. Near-money refers to those objects which can be held with little loss of liquidity

(iv) Metallic Money and Paper Money:

This classification is based upon the content of a unit of money. Money made of some metal like gold and silver is called metallic money. On the other hand, money made of paper, such as currency notes, is called paper money.

Metallic money is sub-classified into:

(a) Standard Money, and

(b) Token Money.

Standard money is one whose intrinsic value is equal to its face value. It is made up of some precious metal and has free coinage. Token money is that form of money whose face value is higher than its intrinsic value. Indian rupee coin is an example of token money. Paper money comprises bank notes and government notes which circulate without difficulty.

Paper money is classified into following parts:

(a) Representative paper money, which is 100 per cent backed and is fully redeemable in some precious metal.

(b) Convertible paper money, which can be converted into standard coins at the option of the holder. It is not fully backed by precious metals.

(c) Inconvertible paper money, which cannot be converted into full-bodied money. Indian one rupee note is a good example of inconvertible paper money.

(d) Fiat money, which is issued by the government of the country under emergency conditions. It does not have any backing of reserve.

(v) Credit Money:
It is also known as bank money. This consists of deposits of the people held with the banks, which are payable on demand by the depositors. Cheques, drafts, bills of exchange, etc., are examples of credit money.

Modern Forms of Money:

1. Currency:
The currency is a country's unit of exchange issued by their government or central bank whose value is the basis for trade. Currency includes both metallic money (coins) and paper money that is in public circulation.

(a) Metallic Money:
Metallic money refers to the coins which are used for small transactions. Coins are most often issued by the government. Examples of coins are 50 paise coins, and 1, 2, 5 and 10 rupee coins.

(b) Paper Money:
It refers to paper notes and used for large transactions. Each currency note carries the legend, 'I promise to pay the bearer the sum of 50/100 rupees' depending on the value of note. The currency notes are duly signed by the Governor of RBI.

Simply, the meaning of legend is that it can be converted into other notes or coins of equal value. Examples of currency notes are 1, 2, 5, 10, 20, 50, 100, 500 and 1000 taka notes.

2. Bank Money:
It refers to money deposited by people in the bank on the basis of which cheques can be drawn. Customers of the bank deposit coins and currency notes in the bank for safe-keeping, money transferring and also to get interest on the deposited money.

3. Legal Tender Money (Force Tender):
Legal tender money is the currency which has got legal sanction or approval by the government. It means that the individual is bound to accept it in exchange for goods and services; it cannot be refused in settlement of payments of any kind.

4. Near Money:
It is a term used for those which are not cash but highly liquid assets and can easily be converted into cash on short notice such as bank deposits and treasury bills. It does not function as a medium of exchange in everyday

purchases of goods and services.

5. Electronic Money:

Electronic money (also known as e-money, electronic cash, electronic currency, digital money, digital cash or digital currency) involves computer networks to perform financial transactions electronicallyIt exchange funds every day without the physical movement of any paper money. This would eliminate the use of cheques and reduce the need for currency.

6. Fiat Money:

Fiat money is any money whose value is determined by legal means. The term fiat currency and fiat money relate to types of currency or money whose usefulness results not from any intrinsic value or guarantee that it can be converted into gold or another currency but from a government's order (fiat) that it must be accepted as a means of payment.

Importance of Money:

Money plays a significant role in modern economy. It has an active role in economic activities.

Importance of money in an economy can be discussed as below:

1. Money and Production:

Money helps in various ways in the process of production. Money can help producers to decide, plan, execute and manage the production activities. Moreover, the existence of money helps the producers to assess the quality and quantity of demand of a consumer.

2. Money and Consumption:

Money has a great importance in consumption. Consumers with the help of the money can easily decide, what they want and how much. They have a ready command over the goods and services. Moreover, they can postpone their demands, if required.

3. Money and Distribution:

Money has made it possible to distribute the reward accurately and conveniently among the various factors of production. The reward can be distributed in terms of wages, rent, interest and profit in the form of money.

4. Removal of the Difficulties of Barter:

There were some difficulties attached to the barter system of exchange, i.e., lack of double coincidence of wants, problem of measurement of value, problem of future payment, etc. Invention of money has overcome all the difficulties of barter system. There is no need to find double coincidence of wants and value can be measured easily in terms of money.

5. Money and Capital Formation:

Money is essential to facilitate capital formation. Savings of people can be mobilized in the form of money and these mobilized savings can be invested in more profitable ventures. Financial institutions are the part of this process. They mobilize the savings and channelize them in productive process.

6. Money and Public Finance:

Public finance deals with the income and expenditure of the government. Government receives its income in the form of money through taxes and other means and make expenditures in development and administrative processes.

7. External Trade:

Money has facilitated trade not only inside the country but also outside countries. With the use of money, goods and services can easily and rapidly be exchanged. Though in external trade foreign currencies are used in receipts and payments but they are exchanged with the help of domestic currencies.

8. Money and Economic Development:

Supply of money in a country affects its economic development. If the money supply is more, then it may lead to inflationary situation in the economy which may hamper growth. Similarly, if the supply of money is lesser than what is required then there will be shortage of liquidity which will lead to lesser investments and hence lesser employment.

The End

Concept of Money Supply and its Measurement

Definition: The money supply is the total stock of money circulating in an economy. The circulating money involves the currency, printed notes, money in the deposit accounts and in the form of other liquid assets.

Money supply refers to the amount of domestic currency that circulates in a national economy during a specified period. Money supply includes cash, coins, and money held in savings and checking accounts for short-term payments and investments.

Money supply plays a crucial role in the determination of price level and interest rate. In economic analysis it is generally presumed that money supply is determined by the policy of Central Bank of a country and the Government.

The Concept of Money Supply and its Measurement:

By money supply we mean the total stock of monetary media of exchange available to a society for use in connection with the economic activity of the country.

According to the standard concept of money supply, it is composed of the following two elements:

1. Currency with the public,

2. Demand deposits with the public.

Before explaining these two components of money supply two things must be noted with regard to the money supply in the economy.

First, the money supply refers ‘to the total sum of money available to the public in the economy at a point of time. That is, money supply is a stock concept in sharp contrast to the national income which is a flow representing the value of goods and services produced per unit of time, usually taken as a year Secondly, money supply always refers to the amount of money held by the public. In the term public are included households, firms and institutions other than banks and the government. The rationale behind considering money supply as held by the public is to separate the producers of money from those who use money to fulfill their various types of demand for money.

Since the Government and the banks produce or create money for the use by the public, the money (cash reserves) held by them are not used for transaction and speculative purposes and are excluded from the standard measures of money supply. This separation of producers of money from the users of money is important from the viewpoint of both monetary theory and pol Let us explain the two components of money supply at some length.

Currency with the Public:

In order to arrive at the total currency with the public in India we add the following items:

1. Currency notes in circulation issued by the Bangladesh Bank.

2. The number of rupee notes and coins in circulation.

3. Small coins in circulation.

It is worth noting that cash reserves with the banks have to be deducted from the value of the above three items of currency in order to arrive at the total currency with the public. This is because cash reserves with the banks must remain with them and cannot therefore be used for making payments for goods or by any commercial banks' transactions.

It may further be noted that these days paper currency issued by Bangladesh Bank(BB) are not fully backed by the reserves of gold and silver, nor it is considered necessary to do so. Full backing of paper currency by reserves of gold prevailed in the past when gold standard or silver standard type of monetary system existed.

According to the modem economic thinking the magnitude of currency issued should be determined by the monetary needs of the economy and not by the available reserves of gold and silver. As in other developed countries, since 1967 Bangladesh Bank (BB) follows Minimum Reserve System of issuing currency.

Under this system, minimum reserves of Tk 200 crores of gold and other approved securities (such as dollars, pound sterling, etc.) have to be kept and against this any amount of currency can be issued depending on the monetary requirements of the economy.

BB is not bound to convert notes into equal value of gold or silver. In the present times currency is inconvertible. The word written on the note, say 100 taka notes and signed by the governor of BB that ‘I promise to pay the bearer a sum of 100 taka’s is only a legacy of the past and does not imply its convertibility into gold or silver.

Another important thing to note is that paper currency or coins are fiat money, which means that currency notes and metallic coins serve as money on the bases of the fiat (i.e. order) of the Government. In other words, on the authority of the Government no one can refuse to accept them in payment for the transaction made. That is why they are called legal tender.

Demand Deposits with the Public:

The other important components of money supply are demand deposits of the public with the banks. These demand deposits held by the public are also called bank money or deposit money. Deposits with the banks are broadly divided into two types: demand deposits and time deposits.

Demand deposits in the banks are those deposits which can be withdrawn by drawing cheques on them. Through cheques these deposits can be transferred to others for making payments from which 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. It may be noted that demand deposits are fiduciary money proper. Fiduciary money is one which functions as money on the basis of trust of the persons who make payment rather than on the basis of the authority of Government.

Thus, despite the fact that demand deposits and cheques through which they are operated are not legal' tender, they functions as money on the basis of the trust commanded by those who draw cheques on them. They are money as they are generally acceptable as medium of payment.

Bank deposits are created when people deposits currency with them. But far more important is that banks themselves create deposits when they give advances to businessmen and others. On the basis of small cash reserves of currency, they are able to create a much larger amount of demand deposits through a system called fractional reserve system which will be explained later in detail.

In the developed countries such as USA and Great Britain deposit money accounted for over 80 per cent of the total money supply, currency being a relatively small part of it. This is because banking system has greatly developed there and also people have developed banking habits.

On the other hand, in the developing countries banking has not developed sufficiently and also people have not acquired banking habits and they prefer to make transactions in currency. However in India after 50 years of independence and economic development the proportion of bank deposits in the money supply has risen to about 50 per cent.

Four Measures of Money Supply:

Several definitions of money supply have been given and therefore various measures of money supply based on them have been estimated.

First, different components of money supply have been distinguished on the basis of the different functions that money performs.

For example, demand deposits, credit card and currency are used by the people primarily as a medium of exchange for buying goods and services and making other transactions. Obviously, they are money because they are used as a medium of exchange and are generally referred to as M_1. Another measure of money supply is M_3 which includes both M_1 and time deposits held by the public in the banks. Time deposits are money that people hold as store of value.

The main reason why money supply is classified into various measures on the basis of its functions is that effective predictions can be made about the likely affects on the economy of changes in the different components of money supply. For example, if M_1 is increasing firstly it can be reasonably expected that people are planning to make a large number of transactions.

On the other hand, if time-deposits component of money-supply measure M_3 which serves as a store of value is increasing rapidly, it can be validly concluded that people are planning to save more and accordingly consume less.

Therefore, it is believed that for monetary analysis and policy formulation, a single measure of money supply is not only inadequate but may be misleading too. Hence various measures of money supply are prepared to meet the needs of monetary analysis and policy formulation.

Recently in Bangladesh as well as in some developed countries, four concepts of money supply have been distinguished. The definition of money supply given above represents a narrow measure of money supply and is generally described as M_1. From April 1977, the Bangladesh Bank has adopted four concepts of money supply in its analysis of the quantum of and variations in money supply. These four concepts of measures of money supply are explained below.

1. Money Supply M1 or Narrow Money:

This is the narrow measure of money supply and is composed of the following items:

$M_1 = C + DD + OD$

Where

C = Currency with the public

DD = Demand deposits with the public in the Commercial and Cooperative Banks.

OD = Other deposits held by the public with Bangladesh Bank

The money supply is the most liquid measure of money supply as the money included in it can be easily used as a medium of exchange, that is, as a means of making payments for transactions.

Currency with the public (C) in the above measure of money supply consists of the followings:

(i) Notes in circulation.

(ii) Circulation of rupee coins as well as small coins

(iii) Cash reserves on hand with all banks.

Note that in measuring demand deposits with the public in the banks (i.e., DD), inter-bank deposits, that is, deposits held by a bank in other banks are excluded from this measure.

In the other deposits with Bangladesh Bank (i.e., OD) deposits held by the Central and State Governments and a few others such as BB Employees Pension and Provident Funds are excluded.

However, these other deposits of Bangladesh Bank include the following items:

(i) Deposits of Institutions such as Commercial banks etc.

(ii) Demand deposits of foreign Central Banks and Foreign Governments.

(iii) Demand deposits of IMF and World Bank.

It may be noted that other deposits of Bangladesh Bank constitute a very small proportion (less than one per cent).

Money Supply M2:

M_2 is a broader concept of money supply in India than M_1. In addition to the three items of M_1, the concept of money supply M_2 includes savings deposits with the post office savings banks. Thus,

M_2 – M_1 + Savings deposits with the post office savings banks.

The reason why money supply M_2 has been distinguished from M_1 is that saving deposits with post office savings banks are not as liquid as demand deposits with Commercial and Co-operative Banks as they are not chequable accounts. However, saving deposits with post offices are more liquid than time deposits with the banks.

Money Supply M3 or Broad Money:

M_3 is a broad concept of money supply. In addition to the items of money supply included in measure M_1, in money supply M^ time deposits with the banks are also included. Thus

$M_3 = M_1$ + Time Deposits with the banks.

It is generally thought that time deposits serve as store of value and represent savings of the people and are not liquid as they cannot be withdrawn through drawing cheque on them. However, since loans from the banks can be easily obtained against these time deposits, they can be used if found necessary for transaction purposes in this way. Further, they can be withdrawn at any time by forgoing some interest earned on them.

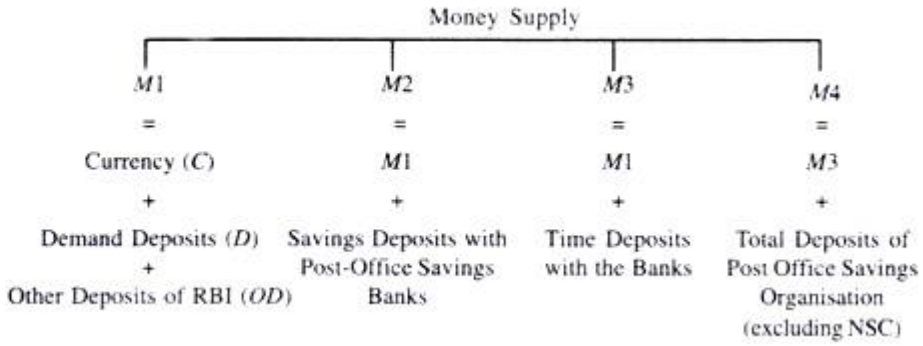
It may be noted that recently M3 has become a popular measure of money supply. The working group on monetary reforms under the chairmanship of Late Prof. Sukhamoy Chakravarty recommended its use for monetary planning of the economy and setting target of the growth of money supply in terms of M3.

Therefore, recently BB in its analysis of growth of money supply and its effects on the economy has shifted to the use of M_3 measure of money supply. In the terminology of money supply employed by BB till April 1977, this M3 was called Aggregate Monetary Resources (AMR).

Money Supply M4:

The measure M4 of money supply includes not only all the items of M_3 described above but also the total deposits with the post office savings organisation. However, this excludes contributions made by the public to the national saving certificates. Thus, M4 = M3 + Total Deposits with Post Office Savings Organisation.

Let us summarise the four concepts of money supply as used by Reserve Bank of India in the following tabular form:



Demand for Money

The demand for money comes from the desire to hold liquid assets of which money is the only perfect example. It may be noted that money is not demanded for its own sake but because it can be used to purchase economic goods and services.

Keynes argued that there are three motives for holding money. First, individuals will demand money to finance their daily purchases of goods and services. This is known as the transactions motive. Secondly, people will demand money as a contingency against unforeseen expenditures. This is known as the precautionary motive. Thirdly, people will hold money as a store of wealth.

The motives lying behind liquidity preference (or why people desire to hold money) can be analysed as follows:

(1) The transactions motive:

Liquid balances are necessary to bridge the interval between receipt of income and outlay. Income is received periodically. A man who gets his wages once a month must keep enough cash in his hands or in his current account to carry on his day-to-day purchases between one pay day and another.

The same considerations apply to businesspeople and industrialists. They also must keep some money in hand for their day-to-day transactions. The amount of money, required for this purpose, depends upon the general level of business activity.

(2) The precautionary motive:

Liquid balances are required to be kept in hand to provide for emergencies like sickness or accident. Everyone likes to keep some money in hand by way of precaution against such contingent liabilities and unforeseen expenses.

(3) The speculative motive:

Liquid balances are held with the expectation of finding better uses for them in the future. Opportunities for the purchase of goods or of bonds, on favourable terms, may come any time and everyone likes to keep some money at hand to avail himself of such opportunities. Money kept as a store of wealth comes within this category. (Keynes)

Balances held from the transactions or the precautionary motives are little affected by the rate of interest. But those held for the speculative purposes are particularly sensitive to it.

The demand for money depends on three main factors: national income, the price level and the rate of interest. Transactions demand and precautionary demand vary directly with the first two factors but speculative demand for money vary inversely with the market rate of interest.

Chapter Two: Value of Money and its Measurement

Value of Money:

The value of money means purchasing power of money. Apart from exchange value of money it has no other independent value. In other words, the money is always related with its exchange value. As we know the eye whether of human person or animal does not have its own light, similarly the eye can see only with either by artificial or natural light. In the same way, the value of money can be judged or perceived only when it is related with its power of purchase.

In the words of Crowther “The value of money is what is will buy.” In other words the value of money depends on its purchasing power. In this connection the other definition of Robertson may also be referred. As per this definition— **“The value of money means the amount or things in general which will be given in exchange for a unit of money.”**

In this way the value of the money depends on its purchasing power either of a commodity or other services. It is also evident that the value of money and value of commodity has opposite relationship. This means when there is an increase in the value of commodity, the value of money will decrease.

Inflation

Inflation is defined as a rise in the general price level. In other words, prices of many goods and services such as housing, apparel, food, transportation, and fuel must be increasing in order for inflation to occur in the overall economy. If prices of just a few types of goods or services are rising, there isn't necessarily inflation.

Main Causes of Inflation

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Three main causes of inflation derived by economists are as follows:

1. Cost-push Inflation

2. Demand-pull Inflation

3. Monetary Inflation!

Inflation is not a random increase in the general price level. While examining the causes of inflation, therefore, it is necessary to consider the reasons for a rise in the price level over a period of time. Economists divide the causes into three main categories.

These are cost-push, demand- pull and monetary. The consequences of inflation can not only be influenced by its cause, but also its rate, inflation rates of other countries and the action taken by the government to offset its effects.

1. Cost-push Inflation:

Cost-push inflation occurs when the price level is pushed up by increases in the costs of production. If firms face higher costs, they will usually raise their prices to maintain their profit margins. There are a number of reasons for an increase in costs.

One is wages increasing more than labour productivity. This will increase labour costs. As labour costs form the highest proportion of total costs in many firms, such a rise can have a significant impact on the price level. It will also not be a one-off increase. The initial rise in the price level is likely to cause workers to press for even higher wages, leading to a wage-price spiral.

Another important reason is increase in the cost of raw materials. Some raw materials, most notably oil, can change the price by large amounts. Other causes of cost-push inflation are increases in indirect taxes, higher cost of capital goods and increase in profit margins by firms.

Cost-push inflation can be illustrated on an aggregate demand and aggregate supply diagram. Higher costs of production shift the AS curve to the left and this movement forces up the price level, as shown in Fig. 1.

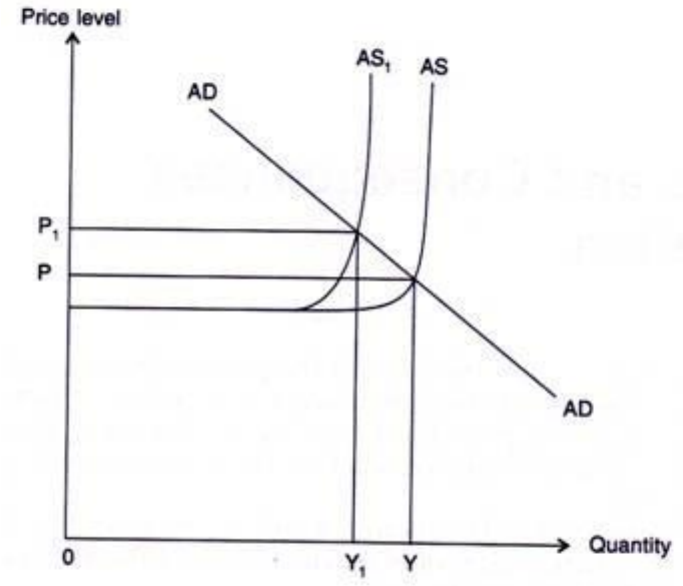

Fig. 1 Cost-push inflation

2. Demand-pull Inflation:

Demand-pull inflation occurs when the price level is pulled up by an excess demand. Aggregate demand for a country's products can increase due to higher consumption, higher investment, higher government expenditure or higher net exports. Such an increase in aggregate demand will not necessarily cause inflation, if aggregate supply can extend to match it.

When the economy has plenty of spare capacity, with unemployed workers and unused machines, higher aggregate demand will result in higher output but no increase in the price level. If, however, the economy is experiencing a shortage of some resources, for example – skilled workers, then aggregate supply may not be able to rise in line with aggregate demand and inflation occurs. In a situation of full employment of resources it would not be possible to produce any more output. As a result, any rise in demand will be purely inflationary as shown in Fig. 2.

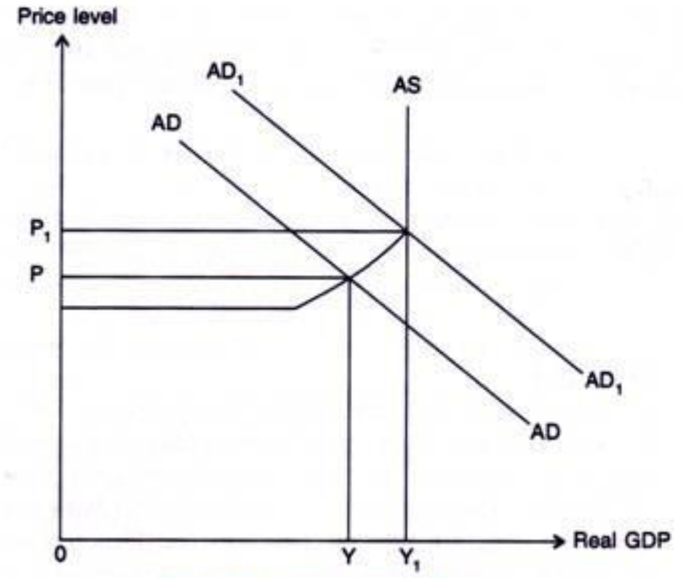

Fig. 2 Demand-pull inflation

3. Monetary Inflation:

Monetary inflation is a form of demand-pull inflation. In this case, excess demand is created by an excessive growth of the money supply. A group of economists, appropriately called monetarists, believe that the only cause of inflation is the money supply increasing faster than output. They argue that if the money supply increases, people will spend more and this will lead to an increase in prices.

In explaining their view, monetarists examine the relationship between the money supply and the velocity of circulation on one hand and the price level and output on the other. By definition, both sides must be equal as both represent total expenditure.

For example, if the money supply is $100bn and, on average, each dollar changes hands four times, a total of $400bn will be spent. If an output of $200bn products is produced, the average price would be $2 (200bn x $2 = $400bn). If the money supply increases by 50% to $150bn and output and the velocity of circulation remain unchanged, the average price would rise to $3 ($150bn x 4/200bn).

Effects of Inflation:

People's desires are inconsistent. When they act as buyers they want prices of goods and services to remain stable but as sellers they expect the prices of goods and services should go up. Such a happy outcome may arise for some individuals; “but, when this happens, others will be getting the worst of both worlds.”

When price level goes up, there is both a gainer and a loser. To evaluate the consequence of inflation, one must identify the nature of inflation which may be anticipated and unanticipated. If inflation is anticipated, people can adjust with the new situation and costs of inflation to the society will be smaller.

In reality, people cannot predict accurately future events or people often make mistakes in predicting the course of inflation. In other words, inflation may be unanticipated when people fail to adjust completely. This creates various problems.

One can study the effects of unanticipated inflation under two broad headings:

(a) Effect on distribution of income and wealth; and

(b) Effect on economic growth.

(a) Effects of Inflation on Distribution of Income and Wealth:

During inflation, usually people experience rise in incomes. But some people gain during inflation at the expense of others. Some individuals gain because their money incomes rise more rapidly than the prices and some lose because prices rise more rapidly than their incomes during inflation. Thus, it redistributes income and wealth.

Measures for Controlling Inflation (With Diagram)

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Inflation is considered to be a complex situation for an economy. If inflation goes beyond a moderate rate, it can create disastrous situations for an economy; therefore is should be under control.

It is not easy to control inflation by using a particular measure or instrument.

The main aim of every measure is to reduce the inflow of cash in the economy or reduce the liquidity in the market.

The different measures used for controlling inflation are shown in Figure-5:

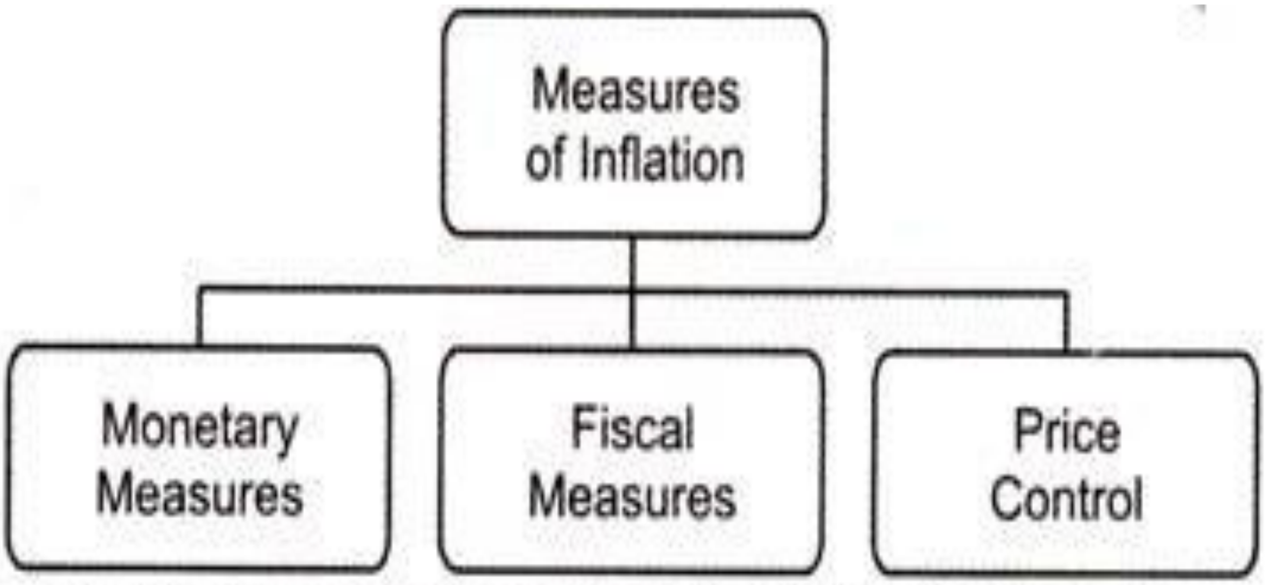


Figure-5: Different Measures for Controlling Inflation

The different measures (as shown in Figure-5) used for controlling inflation are explained below.

1. Monetary Measures:

The government of a country takes several measures and formulates policies to control economic activities. Monetary policy is one of the most commonly used measures taken by the government to control inflation.

In monetary policy, the central bank increases rate of interest on borrowings for commercial banks. As a result, commercial banks increase their rate of interests on credit for the public. In such a situation, individuals prefer to save money instead of investing in new ventures.

This would reduce money supply in the market, which, in turn, controls inflation. Apart from this, the central bank reduces the credit creation capacity of commercial banks to control inflation.

The monetary policy of a country involves the following:

(a) Rise in Bank Rate:

Refers to one of the most widely used measure taken by the central bank to control inflation.

The bank rate is the rate at which the commercial bank gets a rediscount on loans and advances by the central bank. The increase in the bank rate results in the rise of rate of interest on loans for the public. This leads to the reduction in total spending of individuals.

The main reasons for reduction in total expenditure of individuals are as follows;

(i) Making the borrowing of money costlier:

Refers to the fact that with the rise in the bank rate by the central bank increases the interest rate on loans and advances by commercial banks. This makes the borrowing of money expensive for general public.

Consequently, individuals postpone their investment plans and wait for fall in interest rates in future. The reduction in investments results in the decreases in the total spending and helps in controlling inflation.

(ii) Creating adverse situations for businesses:
Implies that increase in bank rate has a psychological impact on some of the businesspersons. They consider this situation adverse for carrying out their business activities. Therefore, they reduce their spending and investment.

(iii) Increasing the propensity to save:
Refers to one of the most important reason for reduction in total expenditure of individuals. It is a well-known fact that individuals generally prefer to save money in inflationary conditions. As a result, the total expenditure of individuals on consumption and investment decreases.

(b) Direct Control on Credit Creation:
Constitutes the major part of monetary policy.

The central bank directly reduces the credit control capacity of commercial banks by using the following methods:
(i) Performing Open Market Operations (OMO):
Refers to one of the important method used by the central bank to reduce the credit creation capacity of commercial banks. The central bank issues government securities to commercial banks and certain private businesses.

In this way, the cash with commercial banks would be spent on purchasing government securities. As a result, commercial bank would reduce credit supply for the general public.

(ii) Changing Reserve Ratios:
Involves increase or decrease in reserve ratios by the central bank to reduce the credit creation capacity of commercial banks. For example, when the central bank needs to reduce the credit creation capacity of commercial banks, it increases Cash Reserve Ratio (CRR). As a result, commercial banks need to keep a large amount of cash as reserve from their total deposits with the central bank. This would further reduce the lending capacity of commercial banks. Consequently, the investment by individuals in an economy would also reduce.

2. Fiscal Measures:

Apart from monetary policy, the government also uses fiscal measures to control inflation. The two main components of fiscal policy are government revenue and government expenditure. In fiscal policy, the government controls inflation either by reducing private spending or by decreasing government expenditure, or by using both.

It reduces private spending by increasing taxes on private businesses. When private spending is more, the government reduces its expenditure to control inflation. However, in present scenario, reducing government expenditure is not possible because there may be certain on-going projects for social welfare that cannot be postponed.

Besides this, the government expenditures are essential for other areas, such as defense, health, education, and law and order. In such a case, reducing private spending is more preferable rather than decreasing government expenditure. When the government reduces private spending by increasing taxes, individuals decrease their total expenditure.

For example, if direct taxes on profits increase, the total disposable income would reduce. As a result, the total spending of individuals decreases, which, in turn, reduces money supply in the market. Therefore, at the time of inflation, the government reduces its expenditure and increases taxes for dropping private spending.

3. Price Control:

Another method for ceasing inflation is preventing any further rise in the prices of goods and services. In this method, inflation is suppressed by price control, but cannot be controlled for the long term. In such a case, the basic inflationary pressure in the economy is not exhibited in the form of rise in prices for a short time. Such inflation is termed as suppressed inflation.

The historical evidences have shown that price control alone cannot control inflation, but only reduces the extent of inflation. For example, at the time of wars, the government of different countries imposed price controls to prevent any further rise in the prices. However, prices remain at peak in different economies. This was because of the reason that inflation was persistent in different economies, which caused sharp rise in prices. Therefore, it can be said inflation cannot be ceased unless its cause is determined.

Chapter three : Islamic Banking: Some Conceptual Issues

What is Islamic Banking

Islamic banking has been defined in a number of ways. The definition of Islamic bank, as approved by the General Secretariat of the OIC, is stated in the following manner.

"An Islamic bank is a financial institution whose status, rules and procedures expressly state its commitment to the principle of Islamic Shariah and to the banning of the receipt and payment of interest on any of its operations"(Ali & Sarkar 1995, pp.20-25).

It appears from the above definitions that Islamic banking is systems of financial intermediation that avoids receipt and payment of interest in its transactions and conducts its operations in a way that it helps achieve the objectives of an Islamic economy. Alternatively, this is a banking system whose operation is based on Islamic principles of transactions of which profit and loss sharing (PLS) is a major feature, ensuring justice and equity in the economy. That is why Islamic banks are often known as PLS-banks.

Objectives of Islamic Banking

The primary objective of establishing Islamic banks all over the world is to promote, foster and develop the application of Islamic principles in the business sector. More specifically, the objectives of Islamic banking when viewed in the context of its role in the economy are listed as following:

To offer contemporary financial services in conformity with Islamic *Shariah*;

To contribute towards economic development and prosperity within the principles of Islamic justice;

Optimum allocation of scarce financial resources; and

To help ensure equitable distribution of income.

These objectives are discussed below.

Offer Financial Services: Interest-based banking, which is considered a practice of *Riba* in financial transactions, is unanimously identified as anti-Islamic. That means all transactions made under conventional banking are unlawful according to Islamic *Shariah*. Thus, the emergence of Islamic banking is clearly intended to provide for *Shariah*approved financial transactions.

Islamic Banking for Development*:* Islamic banking is claimed to be more development-oriented than its conventional counterpart. The concept of profit sharing is a built-in development promoter since it establishes a direct relationship between the bank's return on investment and the successful operation of the business by the entrepreneurs.

Optimum Allocation of Resources: Another important objective of Islamic banking is the optimum allocation of scarce resources. The foundation of the Islamic banking system is that it promotes the investment of financial resources into those projects that are considered to be the most profitable and beneficial to the economy.

Islamic Banking for Equitable Distribution of Resources: Perhaps the must important objective of Islamic banking is to ensure equitable distribution of income and resources among the participating parties: the bank, the depositors and the entrepreneurs.

Distinguishing features of Islamic Banking

An Islamic bank has several distinctive features as compared to its conventional counterpart. Chapra (1985, PP.154-57) has outlined six essential differences as below:
Abolition of interest *(Riba)*: Since *Riba* is prohibited in the Quran and interest in all its forms is akin to *Riba*, as confirmed by *Fuqaha* and Muslim economists with rare exceptions, the first distinguishing feature of an Islamic bank must be that it is interest-free.

Adherence to public interest: Activity of commercial banks being primarily based on the use of public funds, public interest rather than individual or group interest will be served by Islamic commercial banks. The Islamic banks should use all deposits, which come from the public for serving public interest and realizing the relevant socio-economic goals of Islam. They should play a goal-oriented rather than merely a profit-maximizing role and should adjust themselves to the different needs of the Islamic economy.

Multi-purpose bank: Another substantial distinguishing feature is that Islamic banks will be universal or multi-purpose banks and not purely commercial banks. These banks are conceived to be a crossbreed of commercial and investment banks, investment trusts and investment -management institutions, and would offer a variety of services to their customers. A substantial part of their financing would be for specific projects or ventures. Their equity-oriented investments would not permit them to borrow short-term funds and lend to long-term investments. This should make them less crisis-prone compared to their capitalist counterparts, since they would have to make a greater effort to match the maturity of their liabilities with the maturity of their assets.

More careful evaluation of investment demand: Another very important feature of an Islamic bank is its very careful attitude towards evaluation of applications for equity oriented financing. It is customary that conventional banks evaluate applications, consider collateral and avoid risk as much as possible. Their main concern does not go beyond ensuring the security of their principal and interest receipts. Since the Islamic bank has a built in mechanism of risk sharing, it would need to be more careful in how it evaluates financing requests. It adds a healthy dimension in the whole lending business and eliminates a whole range of undesirable lending practices.

Work as catalyst of development: Profit-loss sharing being a distinctive characteristic of an Islamic bank fosters closer relations between banks and entrepreneurs. It helps develop financial expertise in non-financial firms and also enables the bank to assume the role of technical consultant and financial adviser, which acts as catalyst in the process of industrialization and development.

Conventional and Islamic banking

Conventional banking is essentially based on the debtor-creditor relationship between the depositors and the bank on the one hand, and between the borrowers and the bank on the other. Interest is considered to be the price of credit, reflecting the opportunity cost of money.

Islam, on the other hand, considers a loan to be given or taken, free of charge, to meet any contingency. Thus in Islamic Banking, the creditor should not take advantage of the borrower. When money is lent out on the basis of interest, more often it happens that it leads to some kind of injustice. The first Islamic principle underlying such kinds of transactions is that "deal not unjustly, and ye shall not be dealt with unjustly" [2:279]. Hence, commercial banking in an Islamic framework is not based on the debtor-creditor relationship.

The second principle regarding financial transactions in Islam is that there should not be any reward without taking a risk. This principle is applicable to both labor and capital. As no payment is allowed for labor, unless it is applied to work, there is no reward for capital unless it is exposed to business risk (Ausaf Ahmed 1995, P.17).

Thus, financial intermediation in an Islamic framework has been developed on the basis of the above two principles. Consequently financial relationships in Islam have been participatory in nature. Several theorists suggest that commercial banking in an interest-free system should be organized on the principle of profit and loss sharing. The institution of interest is thus replaced by a principle of participation in profit and loss. That means a fixed rate of interest is replaced by a variable rate of return based on real economic activities (Mangla & Uppal 1990. pp.179-215, 185). The distinct characteristics which provide Islamic banking with its main points of departure from the traditional interest-based commercial banking system are: (a) the Islamic banking system is essentially a profit and loss sharing system and not merely an interest (*Riba*) banking system; and (b) investment (loans and advances in the Conventional sense) under this system of banking must serve simultaneously both the benefit to the investor and the benefit of the local community as well. The financial relationship as pointed out above is referred to in Islamic jurisprudence as *Mudaraba.*

For the interest of the readers, the distinguishing features of the conventional banking and Islamic banking are shown in terms of a box diagram as shown below:

Conventional Banks	**Islamic Banks**
1. The functions and operating modes of conventional banks are based on manmade principles.	1. The functions and operating modes of Islamic banks are based on the principles of Islamic *Shariah.*
2. The investor is assured of a predetermined rate of interest.	2. In contrast, it promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).
3. It aims at maximizing profit without any restriction.	3. It also aims at maximizing profit but subject to *Shariah*restrictions.
4. It does not deal with *Zakat.*	4. In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to collect and distribute *Zakat.*
5. Leading money and getting it back with interest is the fundamental function of the conventional banks.	5. Participation in partnership business is the fundamental function of the Islamic banks.
6. Its scope of activities is narrower when compared with an Islamic bank.	6. Its scope of activities is wider when compared with a conventional bank. It is, in effect, a multi-purpose institution.
7. It can charge additional money (compound rate of interest) in case of defaulters.	7. The Islamic banks have no provision to charge any extra money from the defaulters.
8. In it very often, bank's own interest becomes prominent. It makes no effort to ensure growth with equity.	8. It gives due importance to the public interest. Its ultimate aim is to ensure growth with equity.
9. For interest-based commercial banks, borrowing from the money market is relatively easier.	9. For the Islamic banks, it is comparatively difficult to borrow money from the money market.
10. Since income from the advances is fixed, it gives little importance to developing	10. Since it shares profit and loss, the Islamic banks pay greater attention to developing

expertise in project appraisal and evaluations.	project appraisal and evaluations.
11. The conventional banks give greater emphasis on credit-worthiness of the clients.	11. The Islamic banks, on the other hand, give greater emphasis on the viability of the projects.
12. The status of a conventional bank, in relation to its clients, is that of creditor and debtors.	12. The status of Islamic bank in relation to its clients is that of partners, investors and trader.
13. A conventional bank has to guarantee all its deposits.	13. Strictly speaking, and Islamic bank cannot do that.

➢ MOBILIZATION OF DEPOSITS

The main function of Islamic banks is to mobilize savings and provide financial support to the entrepreneurs. Depositors receive interest in a predetermined rate for their deposits made with an interest-based bank. Similarly, the investors are to pay a predetermined rate of interest to the bank. The technique, thus, involves each and every partner in the transaction process (i.e. the depositor, the investor and the bank) with the element of interest. Islamic bank, on the other hand, neither pays nor receives interest from any of its transactions thereby saving everybody from the curse of interest.

Islam disapproves hoarding of savings and encourages its productive investment (Chapra 1985). It puts emphasis on savings and the productive use of savings. Thus, the bank assembles the small deposits and savings of individuals into a common pool and makes these deposits available for large investment opportunities, ensuring the productive use of society's savings.

Islamic banking is a response to such exigencies. It mobilizes savings of the common people in line with Islamic *Shariah*. Techniques employed by Islamic banks for saving mobilization are as follows.

Al-Wadiah Account

Islamic banks receive deposits in their *Al-Wadiah* account. This account is similar to the demand deposit account of interest-based banks. Conventional interest-based banks do not pay interest on this type of deposit account. In addition, depositors may withdraw all or a part of the funds deposited in this account without restriction. The term *Al-Wadiah* means deposit of money allowing somebody to claim the funds in the account. The bank as trustee preserves and safe keeps the funds deposited. Thus, depositors feel safe keeping their money with the bank because the bank provides assurance of returning their money on demand.

When an individual opens an *Al-Wadiah* account, he agrees to allow the bank to lend these funds to entrepreneurs seeking financing for their products or activities. In addition, the depositor understands that the bank may earn a profit from its lending activity. However, any losses incurred from this investment activity are totally borne by the bank. The depositor is not liable for any losses incurred from this lending activity.

As the depositors do not take the risk of losses with *Al-Wadiah* accounts, they are not entitled to any profit from the use of their deposits by investors. On the other hand, the bank is entitled to all of the profits, if any, as the bank bears all of the risk.

Depositors are provided with a checkbook. They can withdraw any amount up to the balance at any time. The bank may charge a fee on the account to cover transaction costs. *Al-Wadiah* Deposits are short-term funds. Due to the liquidity to the depositor, they are not a reliable source of deposits to the banks. Thus, banks have to be very careful as to what type of projects is financed.

General *Mudaraba* Account

The *Mudaraba* account of Islamic banks is different from the checking account of an interest-based bank. *Mudaraba* is a form of business contract where one party supplies money and the other manages the business by investing labor and time. Profits generated from the venture are shared by both in a proportion agreed upon at the time of contract. However, in this arrangement, the financier is solely responsible for any loss that may be incurred. The financier of the business is known as *Sahib al Mal*, *Rabbul Mal* or owner of the capital and the manager of the business is called *Mudarib* or entrepreneur.

Banks receive deposits in a *Mudaraba* account on the basis of a *Mudaraba* contract. Generally the *Mudaraba* account is not for any specific duration. Funds deposited in the *Mudaraba* account may only be invested in *Shariah* approved ventures through the application of a legitimate Islamic method of financing. This is why these deposit accounts are given the title *Mudaraba* deposits. Specifically, in this transaction, the depositor is the *sahib al mal* and the bank is the *Mudarib*. As mentioned above, profit sharing percentages are determined at the inception of the contract. It is not uncommon for the profits generated by the investment to be distributed such that the *Sahib al Mal* would receive 50 to 75 percent of the profit and the bank would receive the difference. Islamic banks cannot reduce the ratio of the *sahib al mal*, but it can reduce its own share and increase the share of the *sahib al mal*, if it wishes. Here the relationship between the bank and the depositor is shareholder and not a debtor-creditor relationship as before.

Islamic banks receive deposits in *Mudaraba* accounts that are invested into business ventures by the bank directly or through some other third party. Any profit earned from these investments is distributed among the *Mudaraba* depositors at a predetermined percentage and the bank retains the residual amount as its profit. In the event no profits are earned, the depositors receive nothing for their deposit. In addition, should a loss be incurred, the *Mudaraba* depositors are liable to share in the losses in the proportionate share of their deposits. However, if the loss incurred is due to the fault, negligence or non-adherence of bank rules on behalf of the bank or bank personnel, liability of loss is the banks sole responsibility.

Thus, unlike the deposits in the interest based system where the interest rate return is known with certainty, the returns in a *Mudaraba* account are uncertain. The only thing that is known with certainty is that the depositor will share proportionately in the profits and losses of the lending or investing activities of the bank. In the end, the depositor can withdraw the balance in the account plus or minus any profits or losses incurred from the loans.

It may further be mentioned for the sake of clarity that *Mudaraba* depositors, in spite of being partners in the profits and losses, are not partners in the total profits and losses as in the case of bank shareholders. Rather, they are entitled to share in the profits or losses from the bank's lending activity in the proportion they actually have on deposit in the *Mudaraba* account. Some experts have recommended establishing a loss-offsetting fund in order to ensure that the money deposited by *Mudaraba* depositors is not reduced or exhausted by investments or loans that do not perform well (Ibid, p.44). This would be accomplished by depositing a percent of profits (5% or 10%) from favorable business transactions into a loss offsetting reserve account. The loss offsetting reserve account would then be used to reimburse *Mudaraba* depositors for any losses due to unfavorable business deals.

It should be noted that *Mudaraba* depositors do not share in the other sources of income to the bank such as profits from *Al-Wadiah* accounts, service charges, commissions, and other forms of income etc. Likewise, they are not liable for any losses or expenses incurred by these other banking activities either.

It is important to note that the bank is not entitled to wages, allowances or any other kind of remuneration for their time and labor spent in managing the funds deposited under *Mudaraba* accounts. However, they are entitled to reimbursement for normal and essential expenses associated with the managing of *Mudaraba* deposits.

Islamic banks distribute profit among the *Mudaraba* depositors on the basis of the average amount of money available in each depositor's account for a specific period of time such as one month, three months, six months or one year, depending on the contract.

General *Mudaraba* depositors are provided with passbooks and checkbooks. However, since the bank distributes profits to the deposit account holders, it has some regulatory control over the liquidity of the account. For example, the bank may limit the number of withdrawals allowed. The bank may require prior advance notice before withdrawing money from the account, and the bank may have a minimum required balance restriction on the account. Non-adherence to these conditions may result in the forfeiture of any profits. In addition, the bank may appropriate miscellaneous expenses to the accounts of those depositors who do not follow the account restrictions. Of course, this can only happen if the agreement includes clauses containing such restrictions. As per *Shariah* rules, *Mudaraba* depositors cannot interfere in the activities of the bank and they do not have the right to take part in the management of the bank.

Term *Mudaraba* Account

Islamic banks receive term deposit from their clients. The term deposit is, of course, altogether different from that of the interest-based banks. Fixed term deposits received by Islamic banks are called "Term *Mudaraba* Deposits". Generally an Islamic bank receives these types of deposits for a minimum period of 3 months to 3 years at the maximum. The bank invests the money, and shares any profits with the depositor based upon a percentage agreed upon at the time of contract. In the event a loss in incurred, depositors share the loss in proportion to the deposit in their account. At the end of the term the contract terminates and the depositors withdraw their money, plus or minus any gains or losses. The depositors, if they like, can again deposit their money for a new term under a new contract. No checkbook is issued against a Term *Mudaraba*Deposit, however, Term *Mudaraba* Certificate is provided to the depositor.

Since the term *Mudaraba* deposit has restrictions on the withdrawals, the bank can invest the money in projects that match the term without *concerns* of liquidity. In exchange for this benefit, the bank offers higher rate of profit to a Term *Mudaraba* Deposit than that offered on a General *Mudaraba* Deposit. In fact, the longer the term deposit, the higher the profit sharing percentage and vice versa.

Therefore, the basic difference between a term *Mudaraba* account and a general *Mudaraba* account is the specified term of the deposit. In other words, there is no specific duration or term for a general *Mudaraba* account, whereas the term *Mudaraba* deposit does have specific stated duration or term.

Special *Mudaraba* Account

When an Islamic bank receives a *Mudaraba* deposit for investment in some specific business, sector, or project, the deposit is called a "Special *Mudaraba* Deposit". In this case, an Islamic bank, while receiving deposits, comes to an agreement with the depositors that the money to be received will be invested in some specific business such as the fertilizer or salt business; or in some specific sector like the industrial sector, textile sector, export-import sector; or in some specific investment sector of the bank such as real estate, shipping or a special project. Profits earned from these types of specific projects are distributed between the bank and the Special *Mudaraba* depositors based a previously agreed to percentage. As before, in the event of a loss, the depositors share the loss in an amount proportional to their deposits in the account.

Special *Mudaraba* depositors will share only in the profit and loss of those particular businesses, sectors or projects for which they have deposited their money. They are not impacted by profits or losses from the other operations or projects in the general *Mudaraba* accounts.

In summary, there are three types of *Mudaraba* accounts. First, is the General *Mudaraba* account, which does not have a specified term and is not restricted to being invested in specific project. In addition, deposits may be taken out of the General *Mudaraba* account on relatively short notice. A second type of account is the Term *Mudaraba* account. Just as the name suggests, this account is a time like deposits with a specified maturity, but is similar to the General account in that it is not restricted to specific projects. Third, is the Special *Mudaraba* account. These accounts can either be readily liquid like the General accounts or fixed for a specific term like the Term accounts. In addition, these accounts are invested into specific projects or industry, which is stipulated in the contract.

PROJECT SELECTION CRITERIA

1. WHAT IS A PROJECT?

An industrial project is a proposal for investing resources to develop facilities for the production of goods and services in a systematic manner. A project, whether a new venture or an expansion of the existing facility, is undertaken by entrepreneurs for the purpose of earning profit. The project proposal is prepared by the entrepreneur and submitted to the bank for financial assistance and support. As the bank's interest is linked with the earnings capability of the enterprise, it has to judge the worthiness or suitability of the project by applying suitable appraisal criteria. Any failure on the part of the bank to assess the soundness of the project would seriously affect the profitability of the enterprise. A project can be considered viable if it satisfies the various aspects of the appraisal criteria. The important criteria are discussed in Section 3 below.

2. CHARACTERISTICS OF A SOUND PROJECT

A sound industrial project apart from being technically and economically sound should be capable of producing early profits for both investors and the economy. They should also fit in with the long-term economic objectives of the country. The following are the general characteristics of a sound project:

a) Readiness of a market

b) Advantage in production costs compared to foreign or domestic competitors

c) Long-term value to the economy.

Generally, a technically and economically viable project with a ready market and inherent cost advantage will have a prospect of high commercial profitability to attract investors. Such a project is difficult to find but can be identified if value of the project is judged by adopting scientific criteria. The major criteria for judging the value of a project are factor intensity, the plant size and complexity, foreign exchange benefits commercial profitability and natural economic criteria. Though these criteria are valuable tools for selecting a project, other non-measurable factors like politics, institutions, attitudes, social customs and the belief climate are also important.

Project appraisal provides a rational basis for determining if a project is viable. Appraisal involves detailed investigation into the various aspects of the project. The purpose is to find out whether the project is technically, economically, financially, commercially and managerially sound. The tasks of project appraisal involves determining whether technical investigation, analysis design have been adequate, whether economic study, commercial and financial study have been well done, whether financial structure is sound and whether entrepreneurial and managerial capability of the sponsors are adequate. It also involves evaluating the value of the project to the national economy. There are no standard criteria for project appraisal. Each agency has its own standards. Its objective is to determine whether those standards are met by the project. Islamic banks may develop their own standard project appraisal criteria keeping in view the Islamic principles. The viability of the project should be judged by examining the project in the following aspects.

3. CRITERIA FOR SELECTING A PROJECT

3.1 Technical Criteria

The purpose of technical criteria is to examine whether the project is viable with regard to every engineering and technological aspect of the project's specification and process. The technical feasibility study of a project covers a wide range of activities including a study of the availability cost, quality and accessibility of all the goods and services needed to make the project a success. It includes ensuring that the raw materials, supplies of fuel, power, water, land, labor, and heavy equipment are available in abundance. Further technical study would examine the purpose and design of the project, technology used in the process of production, suitability of the machinery and equipment, availability of technical services and methods of quality control, schedule of implementations and sequence of balanced development of all related technical factors. A well-qualified engineer capable to assess the technical soundness of the project has to be appointed by the bank to review the plans to undertake the job. The technical report on the project should clearly show the appropriateness of the technology used in the production process and operation and its fitness in the coming several years. Any technological advances taking place in the industry that might affect the technical and commercial soundness of the project should be indicated in the technical report of the project. As far as machinery and equipment are concerned the appraiser should particularly examine their detail specification like the year of manufacturing, materials used in it's manufacture, life of the machine, availability of spare parts, and prospects of replacement, to ensure the quality of the machinery and equipment is up to standard.

3.2 Economic Criteria

Economic study of a project begins with a thorough analysis of the market for the product to be made or sold. Obviously no project can be a success unless there is market for its product. In a market study, it is necessary to find out the answers of three questions: (a) How big is the market? (b) To what extent it is likely to grow? and (c) How much of it can the project capture? To get the answers of these questions, the researcher must examine import statistics, which include domestic production of the item and the potential for growth in demand for the product. The critical factor in demand and market analysis is an estimate of the demand for specific product during the life of the proposed project. The size of demand, at any given point, is a function of several variable factors such as the composition of the market, the competition from the other sources of supply of the same product, the possibility of substitute products, and income and price elasticity of demand, market responses to socio-economic patterns, distributive channels and consumption growth levels. Thus, while preparing the market report the analyst must carefully analyze these variables. Any mistake in the projection of demand may result in either excess production capacity or poor capacity utilization. In addition to these, the techniques used for market penetration as well as sales promotion methods should be examined carefully, so that actual sales do not fall short of the target.

3.3 Commercial Criteria

The importance of assessing commercial viability of a project cannot be over emphasized, regardless of whether the project is a new one or an expansion of an existing business. The commercial viability is measured by determining the profitability of the project. Profitability indicates public acceptance of the product and shows that the enterprise can produce competitively. Profits provide the money for repaying the debt incurred to finance the project and are the source for internal financing of expansion.

The commercial viability of the project can be determined by estimating sales revenue, operating cost and profit margin at a given level of production and under a given set of operating conditions. In addition, the analyst should do a pro-forma analysis of the cost of production and profitability taking into consideration capacity of the entire plant, product mix, selling price, unit cost of production as well. The elements of costs covered in this computation are the direct costs including raw materials, chemicals, components, power, and labor. Repairs and maintenance, plant overhead, administrative expenses, packaging cost, sales expenses, financial expenses, and depreciation costs are also important elements of the cost of production. The analyst is to examine each element of the cost of production as well as the soundness of the sales forecast and selling price in determining the profitability of the enterprise.

3.4 Financial Criteria

The acceptability of the project to the bank is also dependent on the financial viability of the project. The financial study involves the analysis of capital structure, working capital financing plan, cash flow potential and profitability. Detailed analysis of proposed financial statements (Balance Sheet, Profit & Loss A/C) provides a useful indication for assessing the financial viability. In addition, calculating the usual financial ratios, debt-service coverage, fixed assets coverage, break-even analysis, return of investment, internal rate of return (IRR) should be examined carefully. The return on investment should be satisfactory compared to the opportunity cost of capital. The internal rate of return should be acceptable to the bank.

3.5 Entrepreneurial Capability Criteria

Assessing entrepreneurial capability of the sponsor is crucially important to the financial institution as the success of the enterprise lies on his capability. The essential entrepreneurial qualities for starting and running an enterprise consist of self-confidence, ability to sense new ideas and translate them into realities, innovative and creative risk taking ability resourcefulness, profit-oriented, future oriented, hard working individuals with initiative, drive and compassion. He should also be capable of planning and managing the enterprise successfully. It is very difficult to assess the enterprising qualities of the sponsor, as there is no standard criterion to assess the enterprising quality.

The evaluation of the entrepreneur should not be limited to assessing the above entrepreneurial qualities, but also to identify that the entrepreneur has a continuous strive for perfection in the industrial activities undertaken by him. Proper evaluation of entrepreneurs may help ensure a self-sustaining enterprise. In a developing country where financial assistance is easily available to setting up new enterprises, there is an inherent risk that unless enough precautions are taken such concessions might encourage dependence on promotional agencies. While evaluating potential entrepreneurs, care should be taken to select those promoters who would not be satisfied with just setting up their own industries, but will collaborate in developing a self-sustained system which will help to further industrial growth of the economy. Managerial ability of the entrepreneur should also be carefully evaluated, as the key factor for successful business operation is the managerial efficiency.

Currently there is no formal analysis put into the evaluation of the entrepreneur at most financial institutions. In order to evaluate the entrepreneurial capability of the sponsor, a bank must develop expertise in this area. One must be equipped with the required knowledge and techniques of evaluating entrepreneurs. The capacity to access entrepreneurial capability can be gained through years of experience of interviewing candidates. One must also have a clear understanding of the methods to be adopted, the characteristic traits and dimensions to be evaluated and the limitations of the techniques. A checklist may also be used to assess the essential qualities of potential entrepreneurs. In addition, modern methods of identifying the managerial qualities and risk taking ability of the entrepreneur should also be used.

3.6 Managerial Criteria

Assessment of managerial capability of the sponsor is crucially important for any financial institutions before agreeing to finance a project. Many enterprises fail due to the lack of managerial skills. Therefore, it is very important to assess the managerial capability of the entrepreneur. If the entrepreneur does not posses managerial competence to run the enterprise, he may employ professional managers. Like entrepreneurial skills, there is no standard criterion to assess managerial ability of the borrower. The managerial capability of the entrepreneur/managers can be assessed by studying the past experience, educational background, specialized training, planning ability, decision making strength, and leadership quality. Managerial competence can also be measured through interview techniques, and understanding his capability with regard to planning orientation and management techniques. In order to assess the planning orientations, a series of questions with regard to his choice of the business, process and production technology may be asked. The objective is to ensure that the candidate has the required knowledge and skills to manage the enterprise.

3.7 Security Criteria

Every financial institution places emphasis on this aspect of the project appraisal process. The security coverage may be given by mortgaging fixed assets and freehold property, hypothetical pledge of machinery and equipment, personal guarantee of the sponsors and comprehensive insurance coverage on the project's assets and goods. It is essential to examine the title of the property and authenticity of the assets very carefully. While emphasis is placed here, it has been observed that the security coverage on a project is not an effective tool for recovering the investment. In addition, a security requirement prevents a good number of emerging entrepreneurs from seeking assistance from the bank. Strict collateral requirements are not compatible with the goal of promoting entrepreneurship by the bank. The time has come for banks to find a compromise with regard to the collateral issue. Perhaps the introduction of a credit guarantee or personal guarantee may be a solution step to the problem arising out of collateral issue.

3.8 Benefit of National Economy Criteria

The suitability of the project can be judged by ascertaining its contribution to employment generation, value added to the economy, import substitution and the promotion of backward and forward linkage industries. The starting point for measuring national economic profitability is the calculation of commercial profitability. To estimate the economic profitability, a series of adjustments are made in the commercial cost and revenue estimates. The adjustments can be classified into three groups:

(a) Adjustments to estimated operating cost items in which the real cost of the economy are either greater or less than the cost to the enterprise.

(b) Adjustments to estimated operating income items in which the real benefit to the economy is either greater or less than to the enterprise.

(c) Adjustments to estimated net operating income of the project to reflect measurable economic costs or benefits to the economy and from those that would affect the project as a commercial enterprise.

A project with high material economic profitability and low commercial profitability may be considered for financial assistance if such project warrants subsidy and special incentives from the government.

The overall decision on financing a project is the combined result of several sub-decisions made at various stages of project appraisal. The appraisal report on various aspects of the project provides a guideline for management who must ultimately decide the enterprise for financial assistance. If the bank has not yet developed a team of expertise to appraise the project, assistance from external competent experts may be sought to undertake this job.

Chapter Three: Commercial Bank

Commercial Bank: Definition, Function, Credit Creation and Significances

Meaning of Commercial Banks:

A commercial bank is a financial institution which performs the functions of accepting deposits from the general public and giving loans for investment with the aim of earning profit.

In fact, commercial banks, as their name suggests, axe profit-seeking institutions, i.e., they do banking business to earn profit.

Functions of Commercial Banks

Functions of commercial banks are classified in to two main categories—(A) Primary functions and (B) Secondary functions.

Let us know about each of them:

(A) Primary Functions:

1. It accepts deposits:

A commercial bank accepts deposits in the form of current, savings and fixed deposits. It collects the surplus balances of the Individuals, firms and finances the temporary needs of commercial transactions. The first task is, therefore, the collection of the savings of the public. The bank does this by accepting deposits from its customers. Deposits are the lifeline of banks.

Deposits are of three types as under:

(i) Current account deposits:

Such deposits are payable on demand and are, therefore, called demand deposits. These can be withdrawn by the depositors any number of times depending upon the balance in the account. The bank does not pay any Interest on these deposits but provides cheque facilities. These accounts are generally maintained by businessmen and Industrialists who receive and make business payments of large amounts through cheques.

(ii) Fixed deposits (Time deposits):

Fixed deposits have a fixed period of maturity and are referred to as time deposits. These are deposits for a fixed term, i.e., period of time ranging from a few days to a few years. These are neither payable on demand nor they enjoy cheque facilities.

They can be withdrawn only after the maturity of the specified fixed period. They carry higher rate of interest. They are not treated as a part of money supply Recurring deposit in which a regular deposit of an agreed sum is made is also a variant of fixed deposits.

(iii) Savings account deposits:

These are deposits whose main objective is to save. Savings account is most suitable for individual households. They combine the features of both current account and fixed deposits. They are payable on demand and also withdraw able by cheque. But bank gives this facility with some restrictions, e.g., a bank may allow four or five cheques in a month. Interest paid on savings account deposits in lesser than that of fixed deposit.

Difference between demand deposits and time (term) deposits:

Two traditional forms of deposits are demand deposit and term (or time) deposit:

(i) Deposits which can be withdrawn on demand by depositors are called demand deposits, e.g., current account deposits are called demand deposits because they are payable on demand but saving account deposits do not qualify because of certain conditions on withdrawal. No interest is paid on them. Term deposits, also called time deposits, are deposits which are payable only after the expiry of the specified period.

(ii) Demand deposits do not carry interest whereas time deposits carry a fixed rate of interest.

(iii) Demand deposits are highly liquid whereas time deposits are less liquid,

(iv) Demand deposits are chequable deposits whereas time deposits are not.

2. It gives loans and advances:

The second major function of a commercial bank is to give loans and advances particularly to businessmen and entrepreneurs and thereby earn interest. This is, in fact, the main source of income of the bank. A bank keeps a certain portion of the deposits with itself as reserve and gives (lends) the balance to the borrowers as loans and advances in the form of cash credit, demand loans, short-run loans, overdraft as explained under.

(i) Cash Credit:

An eligible borrower is first sanctioned a credit limit and within that limit he is allowed to withdraw a certain amount on a given security. The withdrawing power depends upon the borrower's current assets, the stock statement of which is submitted by him to the bank as the basis of security. Interest is charged by the bank on the drawn or utilised portion of credit (loan).

(ii) Demand Loans:

A loan which can be recalled on demand is called demand loan. There is no stated maturity. The entire loan amount is paid in lump sum by crediting it to the loan account of the borrower. Those like security brokers whose credit needs fluctuate generally, take such loans on personal security and financial assets.

(iii) Short-term Loans:

Short-term loans are given against some security as personal loans to finance working capital or as priority sector advances. The entire amount is repaid either in one instalment or in a number of instalments over the period of loan.

Investment:

Commercial banks invest their surplus fund in 3 types of securities:

(i) Government securities, (ii) Other approved securities and (iii) Other securities. Banks earn interest on these securities.

(B) Secondary Functions:
Apart from the above-mentioned two primary (major) functions, commercial banks perform the following secondary functions also.

3. Discounting bills of exchange or bundles:
A bill of exchange represents a promise to pay a fixed amount of money at a specific point of time in future. It can also be encashed earlier through discounting process of a commercial bank. Alternatively, a bill of exchange is a document acknowledging an amount of money owed in consideration of goods received. It is a paper asset signed by the debtor and the creditor for a fixed amount payable on a fixed date. It works like this.

Suppose, A buys goods from B, he may not pay B immediately but instead give B a bill of exchange stating the amount of money owed and the time when A will settle the debt. Suppose, B wants the money immediately, he will present the bill of exchange (Hundi) to the bank for discounting. The bank will deduct the commission and pay to B the present value of the bill. When the bill matures after specified period, the bank will get payment from A.

4. Overdraft facility:
An overdraft is an advance given by allowing a customer keeping current account to overdraw his current account up to an agreed limit. It is a facility to a depositor for overdrawing the amount than the balance amount in his account.

In other words, depositors of current account make arrangement with the banks that in case a cheque has been drawn by them which are not covered by the deposit, then the bank should grant overdraft and honour the cheque. The security for overdraft is generally financial assets like shares, debentures, life insurance policies of the account holder, etc.

Difference between Overdraft facility and Loan:
(i) Overdraft is made without security in current account but loans are given against security.

(ii) In the case of loan, the borrower has to pay interest on full amount sanctioned but in the case of overdraft, the borrower is given the facility of borrowing only as much as he requires.

(iii) Whereas the borrower of loan pays Interest on amount outstanding against him but customer of overdraft pays interest on the daily balance.

5. Agency functions of the bank:

The bank acts as an agent of its customers and gets commission for performing agency functions as under:

(i) Transfer of funds:

It provides facility for cheap and easy remittance of funds from place-to-place through demand drafts, mail transfers, telegraphic transfers, etc.

(ii) Collection of funds:

It collects funds through cheques, bills, bundles and demand drafts on behalf of its customers.

(iii) Payments of various items:

It makes payment of taxes. Insurance premium, bills, etc. as per the directions of its customers.

(iv) Purchase and sale of shares and securities:

It buys sells and keeps in safe custody securities and shares on behalf of its customers.

(v) Collection of dividends, interest on shares and debentures is made on behalf of its customers.

(iv) Acts as Trustee and Executor of property of its customers on advice of its customers.

(vii) Letters of References:

It gives information about economic position of its customers to traders and provides similar information about other traders to its customers.

6. Performing general utility services:

The banks provide many general utility services, some of which are as under:

(i) Traveller's cheques .The banks issue traveler's cheques and gift cheques.

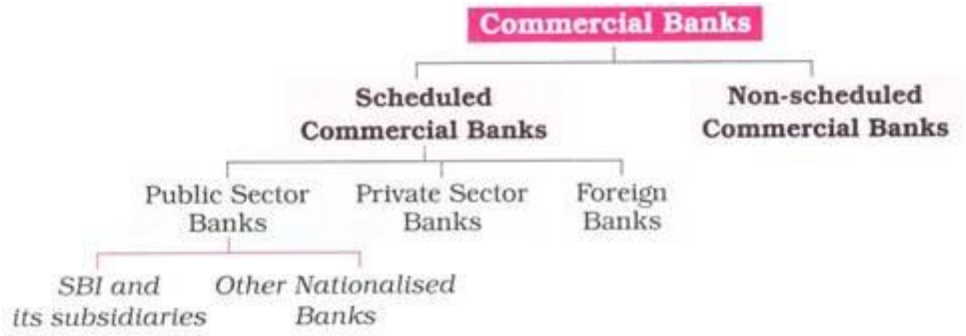
(ii) Locker facility. The customers can keep their ornaments and important documents in lockers for safe custody.

(iii) Underwriting securities issued by government, public or private bodies.

(iv) Purchase and sale of foreign exchange (currency).

Types of Commercial Banks:

The following chart depicts main types of commercial banks .



Scheduled Banks and Non-scheduled Banks:

Commercial banks are classified in two broad categories—scheduled banks and non-scheduled banks.

Scheduled banks are those banks which are included in Second Schedule of Reserve Bank of India. A scheduled bank must have a paid-up capital and reserves of at least Rs 5 lakh. RBI provides special facilities including credit to scheduled banks. Some of important scheduled banks are State Bank of India and its subsidiary banks, nationalised banks, foreign banks, etc.

Non-scheduled Banks:

The banks which are not included in Second Schedule of RBI are known as non-scheduled banks. A non-scheduled bank has a paid-up capital and reserves of less than Rs 5 lakh. Clearly, such banks are small banks and their field of operation is also limited.

A passing reference to some other types of commercial banks will be informative.

Industrial Banks provide finance to industrial concerns by subscribing (buying) shares and debentures of companies and also give long-term loans to acquire machinery, plants, etc. Foreign Exchange Banks are commercial banks which are branches of foreign banks and facilitate international financial transactions through buying and selling of foreign bills.

Agricultural Banks finance agriculture and provide long-term loans for buying tractors and installing tube-wells. Saving Banks mobilise small savings of the people in savings account, e.g., Post office saving bank. Cooperative Banks are organised by the people for their own collective benefits. They advance loans to their members at fair rate of interest.

Significance of Commercial Banks:

Commercial banks play such an important role in the economic development of a country that modern industrial economy cannot exist without them. They constitute nerve centre of production, trade and industry of a country. In the words of Wick-sell, “Bank is the heart and central point of modern exchange economy.”

The following points highlight the significance of commercial banks:

(i) They promote savings and accelerate the rate of capital formation.

(ii) They are source of finance and credit for trade and industry.

(iii) They promote balanced regional development by opening branches in backward areas.

(iv) Bank credit enables entrepreneurs to innovate and invest which accelerates the process of economic development.

(v) They help in promoting large-scale production and growth of priority sectors such as agriculture, small-scale industry, retail trade and export.

(vi) They create credit in the sense that they are able to give more loans and advances than the cash position of the depositor's permits.

(vii)They help commerce and industry to expand their field of operation.

(viii) Thus, they make optimum utilisation of resources possible.

➢ Role of Commercial banks in economic development of a country

1. Capital Formation

Banks play an important role in capital formation, which is essential for the economic development of a country. They mobilize the small savings of the people scattered over a wide area through their network of branches all over the country and make it available for productive purposes.

Now-a-days, banks offer very attractive schemes to attract the people to save their money with them and bring the savings mobilized to the organized money market. If the banks do not perform this function, savings either remains idle or used in creating assets, which are low in scale of plan priorities.

2. Creation of Credit

Banks create credit for the purpose of providing more funds for development projects. Credit creation leads to increased production, employment, sales and prices and thereby they cause faster economic development.

3. Channelizing the Funds to Productive Investment

Banks invest the savings mobilized by them for productive purposes. Capital formation is not the only function of commercial banks. Pooled savings should be distributed to various sectors of the economy with a view to increase the productivity of the nation. Then only it can be said to have performed an important role in the economic development of the nation.

Commercial Banks aid the economic development of the nation through the capital formed by them. In India, loan lending operation of commercial banks subject to the control of the RBI. So our banks cannot lend loan, as they like.

4. Fuller Utilization of Resources

Savings pooled by banks are utilized to a greater extent for development purposes of various regions in the country. It ensures fuller utilization of resources.

5. Encouraging Right Type of Industries

The banks help in the development of the right type of industries by extending loan to right type of persons. In this way, they help not only for industrialization of the country but also for the economic development of the country. They grant loans and advances to manufacturers whose products are in great demand. The manufacturers in turn increase their products by introducing new methods of production and assist in raising the national income of the country.

6. Bank Rate Policy

Economists are of the view that by changing the bank rates, changes can be made in the money supply of a country. In our country, the RBI regulates the rate of interest to be paid by banks for the deposits accepted by them and also the rate of interest to be charged by them on the loans granted by them.

7. Bank Monetize Debt

Commercial banks transform the loan to be repaid after a certain period into cash, which can be immediately used for business activities. Manufacturers and wholesale traders cannot increase their sales without selling goods on credit basis. But credit sales may lead to locking up of capital. As a result, production may also be reduced. As banks are lending money by discounting bills of exchange, business concerns are able to carryout the economic activities without any interruption.

8. Finance to Government

Government is acting as the promoter of industries in underdeveloped countries for which finance is needed for it. Banks provide long-term credit to Government by investing their funds in Government securities and short-term finance by purchasing Treasury Bills.

9. Bankers as Employers

After the nationalization of big banks, banking industry has grown to a great extent. Bank's branches are opened in almost all the villages, which leads to the creation of new employment opportunities. Banks are also improving people for occupying various posts in their office.

10. Banks are Entrepreneurs

In recent days, banks have assumed the role of developing entrepreneurship particularly in developing countries like India. Developing of entrepreneurship is a complex process. It includes the formation of project ideas, identification of specific projects suitable to local conditions, inducing new entrepreneurs to take up these well-formulated projects and provision of counseling services like technical and managerial guidance.

Banks provide 100% credit for worthwhile projects, which is also technically feasible and economically viable. Thus commercial banks help for the development of entrepreneurship in the countr

- **Principles of Commercial Banking**

Principles of Liquidity

A commercial bank offers two types of deposits

- Demand deposits which the bank has to repay on demand like a Savings Account and
- Time deposits which the bank has to repay after the expiry of a certain period

Principles of Profitability

Any commercial enterprise primarily tries to generate profit. A commercial bank is a commercial enterprise as well. Hence, it tries to generate profits.

Principles of Solvency

Commercial banks must be financially sound. Further, they need to maintain a certain required capital for running the business.

Principles of Safety

A commercial bank accepts deposits from its customers and then invests it. However, since it is investing the investor's money it keeps the safety of the money first.

Principles of Collection of Savings

This is one of the most important principles in the current banking scenario. Commercial banks seek huge amounts of idle money from their clients. In fact, bank employees are given targets to collect more savings from people.

Principles of Loans and Investment Policy

A commercial bank primarily earns money through its lending and investing activities. It also ensures that the investor's money is invested in viable projects. Therefore, banks need strong loans and investment policies to earn a good profit.

Principles of Economy

Commercial banks always try to avoid any unnecessary expenditure. Therefore, they try to manage their functions within a set budget and increase their profits.

Principles of providing services

Commercial banks are usually service-focused banks. After all, good service ensures a better reputation and therefore, profits.

Principles of Secrecy

Commercial banks ensure that they keep the accounts of their clients secret. Also, access to the accounts is given only to legitimized persons.

Principles of Modernization

We live in an era of technology as well as modernization. Therefore, to cope with the advancements in the world, commercial banks adopt modern technical services like online banking, mobile banking, etc.

Principles of Specialization

Apart from modernization, we also live in the age of specialization as well as super-specialization. Therefore, commercial banks segment their entire functions into smaller units and place their employees according to their efficiencies.

Principles of Location

Usually, commercial banks choose a location where they think they can find many customers.

Principles of Relation

All commercial banks try to maintain good relations with their existing clients as well as potential customers.

Principles of Publicity

Any successful business needs good publicity. Therefore, most successful businesses advertise to get the attention of more customers. Hence, commercial banks follow the principles of publicity.