Department of Open & Distance Learning

Punjabi University, Patiala

Class : M.A. I (Economics) **Semester : 4**
Paper : 4&5 (Opt.III Money & Banking) **Unit : I**
Medium : English

Lesson No.

1.1 : Central Bank (I)

1.2 : Central Bank (II)

1.3 : Monetary Policy (I)

1.4 : Monetary Policy (II)

1.5 : Credit and Financial System

1.6 : Money Market

1.7 : Capital Market

1.8 : Banking Sector Reforms in India (Review of Narasimham Committee Reports 1991 and 1998)

1.9 : Regulation of Banking System (Laissez Faire Banking)

Department website : www.pbidde.org

LESSON NO. 1.1

CENTRAL BANK (I) (DEFINITION AND FUNCTIONS)

WHAT IS A CENTRAL BANK ?

Central Bank is an institution which has developed historically to meet the needs of the modern monetary and financial system. A modern monetary system has the distinctive characteristic that it is made up of a large number and variety of financial institutions among which the commercial banks are the most outstanding, which have the power to create credit money that is as good as currency money in an exchange transaction. The capacity of the individual bank to create money, coupled with the fact that these commercial banks and other such financial institutions are motivated by the objective of profit maximisation, could create situations that are detrimental to the interests of the economy as a whole. It could lead to a situation of unbridled expansion of credit money as well as to the situation of unwarrantedly restrictive credit. And this may result in great harm to the smooth flow of economic activity. It was, therefore, gradually realized in countries like the U. K., France and other continental countries, where the modern banking and financial system had already attained a high level of development, that there must be established an institution which has the power to control the working of the banking and monetary system of the country in the best economic interest of the national economy. Though some central banking institutions in rudimentary undeveloped form may be said to have existed before the conversion of the Bank of England into the central bank of the U. K. in 1844, yet the history of modern central banks is generally to date from 1844. Just as the British Parliament is regarded as the mother of parliaments, similarly the Bank of England may be regarded as the mother of central banks.

It is impossible to give a perfect definition of Central Banks, for the central banks of various countries as they exist at present do not follow a standard pattern of organisation or functions. Nevertheless, **any definition of a central bank has to be in terms of its functions.** Depending upon what a particular economist regards as the most strategic function of a central bank, he singles out that function in order to arrive at his own definition of a central bank which has led to various definitions of it. For example, **Vera Smith** has defined it as a bank which "has either a complete or a residuary monopoly of note issue." **Shaw,** on the other hand, defines it as a bank which controls credit. **Hawtrey** regards it as a bank which acts as the lender of the last resort. **Kisch and Elkin** look upon it as a bank, the essential duty of which is maintenance of stability of the monetary standard. It is obvious that these few definitions highlight only

a particular function of a central bank and to this extent it is a lop-sided definition. Moreover, these definitions are based on the traditional view of the essential functions of a central bank which, in this view, are conceived to be merely regulatory in character, while the central banks established in the under-developed countries during the post-war period have been assigned not only regulatory but also developmental functions. Therefore it may be better to define a central bank as the apex institution of the banking, monetary and financial structure of a country which performs various regulatory and developmental functions with the motive not of earning profits for itself but of realizing the national economic interest in the best possible manner. Of course, in order to enable it to perform this function, the institution of the central bank is assigned by a government charter certain rights and obligations such as the monopoly of note issue, to act as bankers' bank as well as bank to the government, to act as controller of credit, to act as lender of the last resort, etc.

ADMINISTRATION AND ORGANISATION

Before we go over to explain in detail the various functions of a central bank, it will be useful to have a look at its organisation and administration. As regards this matter, it should be kept in mind that there is no uniformity of administrative organisation among the central banks of the world. Nevertheless, although there are variations in the administrative organisation of the central banks of the different countries of the world, yet there are certain basic features which are common to all and which are sought to be ensured in a variety of ways.

The first point to be noted in this regard is that by the very nature of its fundamental function which is to act in order to achieve in the best possible manner, the well-being of the nation's economy, it has to be organised and administered as an organ of the government of the country concerned. As a widely recognised authority on the theory and practice of central banking. Prof. R. S. Sayers has observed, "The central bank is the organ of government that undertakes the major financial operations of the government and by its conduct of these operations and by other means, influences the behaviour of financial institution so as to support the economic policy of the Government." Since, in the beginning of the evolution of central banking the central bank functioning had been assigned to a privately owned commercial bank as in the case of the Bank of England, the earliest central banks were privately owned. But even these central banks as in the case of the Bank of England had to differ from the usual commercial banks in some important respects on account of their basic orientation. Firstly, even when privately owned they had to make provision for the representation of the government viewpoint. Therefore, they had on their governing bodies people nominated by the Government and closely connected with other organs of the Government. Secondly the central banks, regardless of the

differences in their organisation, have this common feature that unlike the commercial banks they are not administered with the profit maximising motive but, instead, are organised so as to promote the best interest of the national economy through its financial operations. Both of these considerations led, in the post Second World War period, to the establishing of central banks as nationalised institutions rather than private institutions as in the past. So much so that even the Bank of England, the central bank of the U. K. and the mother of modern central banks, was nationalised in 1946.

In addition to the above two important features which are sought to be ensured in the administrative organisation of all central banks, there is another feature too which has to be ensured. Since the central bank of a country can strive to achieve its objective and fulfil its obligations only through the influence of its policies on the policies of the commercial banks and other financial institutions of the country, the administrative organisation of a central bank has to provide for a special relation between it and other financial institutions in general and the commercial banks in particular.

Although a central bank is in a way, an organ of the government, yet it has also been universally conceded that the bank of a country should not be subservient to the Government of the country that happens to be. Despite it being an organ of the government and therefore, in a sense, a part of the government machine and despite the consequent requirement that its policies should fit into the overall economic policy of the national government, it should be enabled to exercise 'independence'. The idea behind ensuring the exercise of 'independence' by the central bank of a country is that it should not allow itself to become a mere hand-maid of the Government but should make an objective assessment of the situations as they arise taking into consideration the overall economic programme of the Government. This 'independence' is specially necessary in as much as it has the monopoly of the issue of currency which, in the absence of some form of constitutional independence to it, may tempt the improvident government to misuse this power of its central bank. The 'independence' of a central bank implies that there should be such provision in its administrative set-up so as to enable it to render disinterested and objective advice to the Government on matters falling within its purview and even to remonstrate with an unwilling Government rather than allow itself to submit to her arbitrary desires and thus jeopardise the national economic interest. As a governor of the Bank of England puts it, the central bank of a country has "the unique right to offer advice and to press such advice even to the point of nagging; but always of course subject to the supreme authority of the government". There must be provision for the exercise of much independence by the central bank in its administrative organisation.

We have above referred to only the basic considerations which are generally sought to be ensured in the administrative organisation of a central bank. The details of it can and do vary from country to country.*

FUNCTIONS OF A CENTRAL BANK

If we look at the contemporary theory and practice of central banking we shall find that central banks, broadly speaking, perform two types of functions which are classified into (1) traditional functions and (2) non-traditional functions. The central banks of the developed countries like those of the U. K., the U. S. A., France, Germany etc. had come into existence when those countries had already attained a fairly high level of economic development and money markets had fairly developed in their countries. Therefore, the governments and central banks of these countries were not bothered about accelerating the pace of economic development. Hence the main concern of the old central banks of the world has been with maintaining the stability of the monetary and financial system of their respective countries and in order to achieve this they have been performing such functions which aim at regulating the monetary and financial system. Hence the traditional central banking functions are performed by not only the older central banks in the underdeveloped countries of the world, they are the necessary functions of all central banks because a stable monetary and financial system is necessary for promoting economic development. They have the added responsibility to help their respective countries achieve an accelerated rate of economic development and to that end they perform some traditional functions which aim at promoting rapid economic development of their respective countries. Hence these non-traditional functions are also referred to as the 'development and promotional' functions.

While the older central banks belonging to the developed countries generally perform the regulatory function, the central banks of the underdeveloped countries perform both the regulatory and the development functions.

Though the various authorities on the subject give emphasis to different functions as the core of the central banking functions, it is, nevertheless, more appropriate to list, following M. H. Dekock, the **traditional functions** of a central bank which are as follows :

(i) It acts as the bank of issue;

(ii) It acts as banker, agent and financial adviser, to the State;

(iii) It acts as the custodian of the member banks' cash reserves;

---

*We do not have enough space here to describe the administrative and organisational set-up of the various important central banks of the world. [The studens who are interested to know these details are advised to consult the relevant chapters of M. H. Dekock's *Central Banking* and R. S. Sayer's *Modern Banking*

(iv) It acts as the custodian of nation's reserves of foreign exchange;

(v) It acts as the lender of the last resort;

(vi) It acts as the bank of settlement and transfer, acting as a clearing house; *and*

(vii) It acts as the controller of credit.

We discuss below these central banking functions in some detail :

(i) As the Bank of Issue

The central bank of a country generally acts as the sole agency authorised to issue currency notes. It has the monopoly of note issue. In fact, it is the oldest among the traditional functions of central banks. The main reasons for granting the monopoly right of note issue to the central bank of a country are as follows :

First, it facilitates the task of the central bank in controlling the total volume of bank credit in order to maintain the internal and external value of the national currency. It is because the power of commercial banks to create credit money depends ultimately on the amount of cash in their possession. The amount of cash in the possession of the commercial banking system of the country can be better controlled if there is only one authority which can issue the national currency than when there are multiple agencies performing the same function. Since the central bank of a country is generally forbidden by its constitution to compete with commercial banks, it is the most appropriate agency to be entrusted with the monopoly right of note issue. Second, the national currency enjoys a much greater prestige, if it is issued by a single agency than when it is issued by a number of banks especially when the payment of the value of notes is guaranteed by the government. Third, it lends uniformity to the national currency and prevents unnecessary confusion that would surely be in the absence of this monopoly right granted to the central bank. Fourth, it ensures a much more effective supervision and control by the state over the way the function of note issue is performed. The irregularities and malpractices, if any, can be easily checked and prevented when there is only one agency performing this function. Fifth, since the central bank is a specialised agency dealing with the technical and complicated matters related to the overall monetary management, it can perform this function better than any other type of banking institution.

It may be asked as to why the monopoly right of note issue cannot be kept by the State to itself instead of entrusting it to the central bank. The most cogent and powerful argument against the state reserving the monopoly of the note issue to itself is that it will provide an easy and standing temptation to the government to misuse the monopoly to have an easy way out of its economic difficulties which may do more harm than good to the national economy. When the State has this monopoly right, there is, as M. H. de Kock has observed, a "comparative ease with which

governments as big disbursers of money can in the long run force the notes in circulation. "On the other hand, the central bank, as we have already observed enjoys a degree of independence of the government and would, therefore, make an objective assessment of the demand for currency and would issue it accordingly. Another authority points out that central bank notes are, with rare exception, issued but on the demand of the recipient parties, while the currency notes issued by the Government can be put into channels of circulation in exchange for services and goods without there being any increase in the production of goods and services and consequently without being preceded by any demand for these currency notes. It leads to the depreciation of the internal and external value of the currency and threatens internal as well as external stability. Hence it is almost unanimously agreed among the authorities on the subject that the right of note issue should be entrusted to the central bank of the country and not to the government.

The above, however, does not imply that the central bank of a country has no constraint on its power to issue currency notes. Usually there are pre-well-defined constraints provided in the charter or legislation which established a central bank. Those constraints are based on various principles of note issue which vary from country to country and even from time to time within the same country. In the beginning, currency notes were introduced to economise on the use of the precious metals and therefore the original central banks were generally required to have full cover in the form of precious metals like gold and silver and the currency was convertible. But in the evolution of this function of central bank this rigidity was replaced with more flexible principles of note issue such as the 'proportional reserve' system, the 'minimum reserve' system etc. A central bank issues currency notes according to the system of note issue that is constitutionally prescribed in its charter.

(ii) As Government Banker

As banker of the government the central bank keeps the surplus funds of the government of the country with itself in the form of government deposits. It also keeps the accounts of the government. When the government is in need of funds to meet temporary shortage of resources the central bank advances short term loans to it. It also gives extra-ordinary advances to the government under extra-ordinary circumstances such as war, depression and other emergencies. It also collects the taxes on behalf of the government.

In addition, the central bank also functions as the fiscal agent and advisor of the Government. If floats loans on behalf of the government and manages the public debt of the government. It also manages the transactions of the government related to the buying and selling of foreign currencies. It also performs the function of advising the government on important matters of economic policy on which the general health

of the economy depends.

(iii) As Custodian of Member Banks' Cash Reserves

The central bank of a country is required to function not only as the bank of the government but also as bankers' bank. As the bankers' bank it has to perform various functions among which one is to keep the cash reserves of the member banks and other banks in the country. In fact, in all countries the member banks are required by law to keep a certain minimum proportion of their total time and demand deposits with the central bank. The central bank does not merely sit over these cash reserves as a custodian but makes a judicious use of it in order to help the economy conduct its business in a smooth and expanding manner. For example, it makes use of these funds to finance economic activities in the country. In fact the centralisation of the cash reserves in the central bank helps in strengthening the economy. It enlarges the credit structure of the country and also makes it more elastic. Moreover, the centralisation of cash reserves enables the central bank to use them in the most effective manner during periods of seasonal stringency and financial crisis.

Moreover, as bankers' bank the central bank also functions as the leader of banks and renders proper advice to the commercial banks and other financial institutions.

(iv) Custodian of Foreign Currency Reserves

Generally the people of a country are required to exchange the foreign currency earned by them for the national currency from the central bank of the country. And if any one wants any foreign currency for bonafide needs, he also has to purchase it from the central bank. Thus the central bank functions as the custodian of the foreign currency reserves of the country. These reserves come handy in situations of the country's adverse balance of payments. They can also be used to stabilise the external value of the currency.

(v) As Lender of the Last Resort

One of the most important functions of modern central banks is to act as lender of the last resort, that is, when financial accommodation in the economy has become sparse and the member banks as well as other financial institutions are in a tight spot and are unable to meet the public demands on them, it becomes the duty of the central banks to come to the rescue of the banking and financial system of the country by providing adequate financial accommodation to them. By acting as lender of the last resort the central bank of a country avoids the panic which can otherwise lead to the liquidation of many banks and thus shatter the whole banking and credit structure of the national economy.

The functions of the central bank as the lender of the last resort is derived from functions of the custodian of the member banks' cash reserves and its function as

bankers' bank. As Walter Bagehot, who was perhaps the first to insist on this function, put it, "Theory suggests, and experience proves that in panic the holders of the ultimate bank reserves should lead to all that brings good securities quickly, freely and readily". Thus when there is financial stringency and panic among the banks and other financial institutions, it becomes the function of the central bank to lend to the public through the member bank freely and vigorously out of the centralised cash reserves with it.

(vi) As Clearing House

In the course of its daily business a commercial bank receives a number of cheques and drafts drawn on the other bank and deposited with it, as other banks deposit cheques and drafts drawn on the former. These claims and cross-claims have to be settled through some machinery. One way of making these settlements is that each bank should settle its account with each other bank separately at the end of certain stipulated period and what is due should be paid and received in cash. This method will not only be very inconvenient and cumbersome but also very uneconomical. Since all the member banks keep their balances with the central bank of the country, this settlement of mutual claims and liabilities can be easily made making transfer entries in the member bank's accounts with the central bank. It is thus that the central bank has come to function as the bank of central settlement and transfer and to act as the clearing house for the member banks.

The clearing house function has now become a necessary function of a central bank. By acting as the clearing house for the settlement of mutual claims of the member banks through mere transfer entries in their account with it, it effects economy of time and labour in addition to the economy in the use of cash. Moreover, through the performing of this function the central bank is also able to get important information on the liquidity of the banking system which can serve it in good stead in formulating its policies. As H. P. Wills has observed. "The clearing house function of the central bank is not only a means of economising cash and capital but is also a means of testing at any time the degree of liquidity which the community is maintaining, a matter which it is essential for the central bank to know from day to day."

(vii) As Controller of Credit

The most important traditional function of central bank is to act as the controller of credit. This function is intimately concerned with its obligation to take appropriate measure for maintaining the internal as well as the external value of the national currency. An uncontrolled expansion of bank money, which is also known as credit money, can set into motion the dangerous process of inflation while a conservative credit money can starve the trade and industry of the country of the necessary funds

and thus cause a slump in the economic activity. Therefore, it is essential that the total volume of credit in the economy is kept in alignment with the growth in economic activity and national output so that the dangers of deflation and inflation are prevented and a reasonable degree of price stability is brought about. Since the price level in a country and changes therein influences the exchange rate of the national currency against the foreign currencies, the stability of the exchange rate of the national currency is linked with the stability of the domestic price level. Therefore, controlling of credit has become very important in a modern economy. (Instruments for credit control will be studied in the next lesson).

In view of the special position of the apex institution that the central bank occupies in the monetary and financial system of a country, this function has to be necessarily performed by it. This function will be studied in detail in the next lesson.

DEVELOPMENT FUNCTIONS

We have explained above the important traditional functions of a central bank. However the central banks of the less developed countries have to perform some non-traditional functions which are mainly connected with the development of the money markets as well as the development of the national economies. Therefore, these non-traditional functions are also called as the 'development functions'. Some of these developmental functions are as follows : (1) Since in the underdeveloped countries money and capital markets are non-existent or are very poorly developed, their central banks are generally assigned the function of developing the money and capital markets of their countries; (2) Connected with this function is the function of integrating the modern organised part of the money market with its indigenous or unorganised part; (3) In so far as most of these countries are dependent on agriculture which is also very backward, the central banks are required to make special arrangements for the supply of agriculture finance at reasonable rates; (4) The central banks of these countries are also expected to play a guiding and facilitating role in the industrialisation process of these countries by helping set up appropriate financial institutions to that end. The assistance for establishing such specialised financial institutions can come about in the form of subscribing to their equity capital and providing them with loans and advances.

Thus the central banks in the underdeveloped countries are expected to perform the function of "a potential development agency" rather than act as a mere "stabilisation device." Moreover, in order to perform the function of a potential development agency they have also to help in building up an institutional framework which is able to meet the developmental needs of their countries. In the words of E. Nevin, they are to perform the function of setting up the "financial infrastructure

of future economic development."

THE RESERVE BANK OF INDIA

The Reserve Bank of India is the central bank of India. It was established in 1935 as a privately owned bank but was nationalised in 1948. It was formed originally to perform the traditional, that is, the regulatory functions, but being the central bank of an underdeveloped country, it has come to adopt the development functions too. Consequently, as it exists today, its role is to regulate the monetary, banking and financial system of the country to achieve monetary stability as well as to promote and develop institutions which could facilitate economic development of the country. S. K. Basu has rightly stated, "India in the present time illustrates the case of a country where the developmental function of the central bank is no less important than its regulatory responsibility."

Evolution : The RBI evolved in the following stages :

— In **January, 1773,** Warren Hastings (Governor of Bengal) recommended establishment of a General Bank in Bengal and Bihar.

— In **1807-08,** a proposal for setting up a General Bank was put forward by Robert Richards (member of Bombay Govt.)

— Keynes submitted a memorandum for setting up a State Bank in India, which would perform the functions of both Central Bank and commercial bank. But World War I broke out, so this scheme could not be implemented.

— In **1921,** the three Presidency Banks were amalgamated to form the Imperial Bank of India. It functioned as Banker's bank and Government's bank, but note issue and management of foreign exchange was the direct responsibility of Central government.

— In **1926,** Hilton-Young Commission suggested the establishment of a central bank, to be called 'Reserve Bank of India'. In **1927,** a Bill for this was introduced in the Legislative Assembly, but was dropped on account of sharp differences of opinion on the bank's ownership and composition of the Board of Directors.

— The Indian Constitutional Reforms in **1933** made it obligatory that the transfer of responsibility from the British government in India to Indian hands was dependent on the establishment of a Reserve Bank free from political influence.

Thus, another bill was introduced in Indian Legislative Assembly in September 1933, and passed in December 1933 by Legislative Assembly, and in 1934 by Council of States. This bill received the Governor General's assent on 6 March, 1934.

The RBI was constituted on 1st April, 1935. It was constituted as a shareholders' bank with a share capital of Rs. 5 crores, divided into shares of Rs. 100/- fully paid-

up. The share capital was owned by private shareholders. Government of India held shares of nominal value of Rs. 2,22,000.

After independence, the decision to nationalise the Bank was taken. Thus, the entire paid-up capital was transferred to the Central Government on 1st January, 1949.

Organisation

General superintendence and direction of the Bank is entrusted to a Central Board of Directors of 20 members, consisting of the Governor, 4 Deputy Governors, one government official from the Ministry of Finance, 10 Directors nominated by the Government of India to give representation to important elements in economic life, and 4 Directors nominated by Central Government to represent four local boards.

Besides the Central Board, there are four Local Boards with headquarters at Mumbai, Chennai, Kolkata and Delhi. Local Boards consist of 5 members, each appointed by central government for a period of four years to represent territorial interests.

The SBI and its associates act as agents of RBI wherever it does not have an office.

FUNCTIONS :

(i) Bank of Issue : RBI acts in India as the sole agency having the right to issue bank notes. It issues currency notes of all denominations except the rupee coins and small coins which are issued by the Government of India through the Finance Ministry. But even these coins are brought into circulation through the Reserve Bank of India. The function of issuing notes is performed through its issue department which, following the model of the Bank of England, is kept separate from its banking department in the sense that the assets and liabilities of the two departments are kept apart. Originally, it had adopted the proportional reserve system for note issue. Accordingly it was required to keep reserves to the tune of forty percent of the note issue in the form of gold bullion, gold coins or sterling securities with the provision that the value of gold in this reserve should not be less than Rs. 40 crores. The proportional reserve system of note issue remained in vogue for more than 20 years. However this system had to be abandoned in 1956 in order to make the monetary system more elastic and responsive to the development needs. The system now in operation is the *minimum* reserve system. According to it, the Reserve Bank can now issue currency notes upto any amount deemed desirable provided it maintains a minimum reserve of Rs. 200 crores in the form of gold and foreign exchange reserves of which the value of gold must not be less than Rs. 115 crores at international prices.

(ii) Banker to Government : Like all central banks the Reserve Bank acts as the

banker of the government. The Reserve bank receives revenues as well as disburses funds on behalf of the union and state governments. It also floats loans on behalf of the union and state government and also makes ways and means advances to them. Moreover it acts as advisor to the Government on all monetary and banking matters.

(iii) Banker's Bank : It also acts as banker's bank and in this capacity it keeps with itself the deposits of the scheduled commercial banks and lends funds to them in times of need. By law the member banks are now required to keep a certain minimum proportion of their total deposits with the Reserve Bank in the form of cash balances. This minimum reserve ratio is variable by the Reserve Bank. The scheduled banks can borrow funds from the Reserve Bank on the basis of eligible securities or get financial accommodation in times of need or stringency by rediscounting bills through it. Thus as banker's bank it also acts as lender of the last resort, for the member banks can always expect to find accommodation with the Reserve Bank when all other sources fail to provide them the necessary funds.

(iv) Custodian of Foreign Exchange Reserves : The Reserve Bank acts as the custodian of all the currency reserves of the country. All the foreign currency earned and brought into the country has to be deposited with it and converted in the national currency through it. Similarly any one requiring foreign currency has to purchase it from the RBI. Thus it acts as the sole agency for foreign exchange transactions. This function is intimately connected with its role to maintain the external value of the rupee.

(v) Controller of Credit : The Reserve Bank of India also acts as the controller of credit in the country. Formerly, it was required to control the total supply of credit in the economy with the objective of maintaining the *internal* value of the rupee; in other words the objective used to be to stabilise the internal price level. However since 1956 the avowed objective of the credit policy of the Reserve Bank has been to bring about "controlled expansion" of credit money. A developing economy like the Indian economy requires expansion of credit to meet the developmental needs but if this expansion is allowed to go out of hand it may set off inflationary pressures which may endanger the development process itself. Hence the Reserve Bank is required to see to it that expansion of credit is kept under control.

The Reserve Bank performs its function as the controller of credit by using the various familiar instruments of credit such as the bank rate policy, the open market operations and variations in the minimum cash reserve ratio, etc. It also makes use of the quantitative methods of credit control.

Developmental Functions : In addition to the usual regulatory and traditional functions enumerated above, the Reserve Bank of India also performs a number of development and promotional functions which have become important in conjunction

with the planned economic development of the country. In this regard, the Reserve Bank promotes banking habits by expanding banking facilities in the rural and semi-urban areas. It has also been trying to fill up the gaps in the credit and financial infrastructure of the economy by establishing and promoting new specialised financial institutions such as the Deposit Insurance Corporation (1962) the Agriculture Refinance Corporation (1963), (now known as National Bank for Agriculture and Rural Development (NABARD), the Unit Trust of India (1964) and Industrial Development Bank of India (1964). Even before these institutions were set up the Reserve Bank has been helping the Indian agriculture by establishing a special Agricultural Credit Department of it in order to provide agricultural credit. It had also been promoting and helping the co-operative credit movement in the country. Besides, through its various Bill Market Schemes it has tried to remove some of the gaps in Indian money market and develop a modern money market in the country.

The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks. This relates to licensing and establishments, branch expansion, liquidity of assets etc. RBI is authorised to carry out periodical inspections of the banks and to call for returns and necessary information from them. This has helped in improving the standard of banking in India.

Suggested Readings

1.	Suraj B. Gupta	:	Montary Economics- Theory, Institutions and Policy.
2.	Gaurav Datt and Ashwani Mahajan	:	Datt and Sundharam Indian Economy (latest edition)
3.	L.M. Bhole	:	Financial Institutions and Markets

Questions For Practice

1. Discuss the funtions of a central bank.
2. Define a central bank. Discuss its developmental funtions.
3. Write a detailed note on Reserve Bank of India
4. Write short notes on: (i) Central Bank as banker's bank (ii) Developmental funtions of RBI. (iii) Why is central bank given the monopoly right of note issue.

LESSON NO. 1.2

CENTRAL BANK (II)

(INSTRUMENTS OF MONETARY MANAGEMENT)

INTRODUCTION :

In the last lesson we had explained the nature and functions of a central bank and had emphasised that the overall function of the central bank of a country is to manage its monetary and financial system in the best economic interest of the country concerned. In order to fulfil this role the central bank of a country, which is the sole authority entrusted with the task of monetary management, generally relies on certain techniques which are known as the instruments of management.

Broadly speaking these instruments of monetary management may be classified into two categories, namely, the general instruments and specific instruments of monetary management. The general instruments refer to such techniques of monetary management and control which affect certain strategic interest rates or influence transactions in certain strategic financial markets. By influencing these strategic interest rates of transactions in strategic financial markets, these instruments exert an indirect effect on the economic activity which can, therefore, be sought to be guided into the desired direction through these instruments. The general instruments of monetary management are usually aimed at influencing either the reserve base of bank credit in the economy or the interest rates in the markets. The most important technique to do this is known as the "open-market operation" which will be explained in greater detail in a subsequent section of this lesson. The other important general instrument, which can be employed by a central bank with a view to achieve the same end, is the bank rate policy and variations in the legally required minimum cash reserves of bank.

On the other hand, the specific instruments of monetary management refer to such controls which the monetary authority generally imposes on particular groups of financial institutions. Their direct effect is on the financial operations of these institutions only but ultimately they affect the operations of other institutions also which might be closely or remotely linked with the former as regards their business operations.

Whatever be the nature of the instruments of monetary management, the general objective of using these instruments is to control the total volume of bank credit and thus to control the total supply of money in the economy in such a manner as to help the economy in attaining the goals of its national economic policy. The function of

the central bank as the controller of credit has, indeed become the most important central banking function.

OBJECTIVES OF CREDIT CONTROL/MONETARY MANAGEMENT

The basic objective of credit control is, of course, to help the economy to achieve the goals of national economic policy. The economic goals which a country set for itself may vary from country to country and from time to time. However, these goals may broadly be listed as follows :

(i) The attainment of some minimum rate of growth in per capita income;
(ii) The attainment of full employment or, where it is deemed to be an impossible task, the attainment of fairly high level of employment;
(iii) The prevention of cyclical fluctuations in the level of income and employment;
(iv) The maintaining of equilibrium in the economy's balance of payment without recourse to borrowing; and
(v) Stabilising the price level in the national economy.

It may be observed that in the short period any one or more of the above can be looked upon as an objective of credit control. But in the long period, as A.D. Bains has observed, "price stability and balance in foreign payment are usually regarded as constraints which influence the extent to which other objectives can be achieved rather than as objectives in themselves." This implies that maintaining perfect or near perfect stability of prices is not the long run objective of a policy of credit control by central banks. If mildly rising price level over a long period helps the high rate of growth in per capita income, the central bank will not aim its credit control policy at bringing about stable prices over the long run. However, if in any short period the price begins to rise rather dangerously or to fall ominously, the controlling of these tendencies in the price level may properly be regarded as short period objective of the central bank policy of credit control.

Similarly, it cannot be an objective of credit control to maintain equilibrium in the economy's balance of foreign payments and receipts from year to year. But over a certain long period the foreign payments and receipts of the economy must balance without taking the help of international financial institutions like the IMF. As regards the foreign sector of the economy the more relevant objective of credit control in the short run is to control the capital movements which is done through appropriate changes in the interest rate.

METHODS OF CREDIT CONTROL/INSTRUMENTS OF MONETARY MANAGEMENT:

The methods of credit control which are generally employed by central banks are the same as the instruments of monetary management about which we spoke in the introductory part of this lesson. These methods or instruments of credit control may be

listed as follows :

(i) The Bank Rate or the Discount Rate Policy;
(ii) The Open Market Operations Policy;
(iii) Variations in Minimum Legal-Cash Reserves;
(iv) Variations in Minimum Secondary Reserve Requirements;
(v) Regulation of Margin Requirement;
(vi) Rationing of Credit;
(vii) Regulation of Consumer Credit;
(viii) Moral Suasion; and
(ix) Direct Action.

These methods of credit control may also be classified into quantitative methods and qualitative methods of credit control. The quantitative methods are those methods of credit control, the overall impact of which is on total quantity or volume of credit in the economy. These methods do not seek to and do not influence the direction of the use of credit. In other words they are nondiscriminatory in character as regards the different uses to which credit can be put. They are similar to what we earlier described as the general instruments of monetary management. On the other hand, the qualitative methods of credit control are those methods which seek to influence the direction of use of credit. They are rather discriminatory in character. **The first four methods listed above, are quantitative methods while the rest are either qualitative or can be employed qualitatively.**

We shall now explain the individual methods of credit control and how they work i.e. how they bring the volume and use of credit in the economy under control.

(i) The Bank Rate Policy

Bank Rate is the rate at which the central bank of a country rediscounts the approved securities directly through the money market and thus makes funds available to the member banks. In other words, it is the rate at which the central bank of a country provides financial accommodation to the member banks.

The working of the mechanism of the bank rate policy is as follows. When in the light of the objective to be pursued, it is found by central bank that the total volume of bank credit in the economy is increasing at a rate higher than the desirable rate or that the total volume of credit has gone up to an extent which would endanger the attainment of the objective (or objectives) of the national economic policy, the central bank will push up the bank rate. It will naturally make the supply of central bank credit to the member banks more costly. It is assumed that the member banks will pass on this increase in their cost of credit to the general borrowing public by raising their own lending rates. Thus the supply of credit in the economy becomes costlier. This will naturally reduce the profit margins of the business firms borrowing funds

from the banks for investments. The marginal business firms may now find their profits turn into losses while the intra-marginal firm will find their profits to have been reduced. The reduced profitability of investment will decrease the demand for bank loans. Consequently, the volume of bank credit in the economy will be reduced.

If, on the other hand, it is thought to be desirable in the interest of the national economic objective to expand the volume of bank credit in the economy, the central bank lowers the bank rate making the central bank credit cheaper for the member banks. It is assumed that the decrease in the bank rate will be followed by a commensurate decrease in the lending rates of the member banks. The decrease in the lending rates of the banks would increase the net profit rate on business investments leading to increased demand for bank loans. Since the banks can now replenish their reserves on easier terms by rediscounting the approved bills with the central banks, they are only too willing to meet this increased demand for bank credit. Consequently, the total volume of credit expands briskly.

The bank rate policy is the oldest weapon of credit control in the hands of central bank. In a well-integrated money market, the bank rate policy may be said to have a threefold significance. First, the bank rate announces in a way the rate at which the general borrowing public should be getting financial accommodation from the banks against specified approved securities. Second, the bank rate announces the rate of interest at which the member banks can borrow funds from the central bank against the specialised approved securities in order to replenish their own cash reserves which are the base of the whole superstructure of commercial bank credit. Third, the bank rate policy reflects the current economic weather and simultaneously indicates the appropriate lending policy that should be adopted by the commercial banks. A rise in the bank rate serves as a red signal to the investing and borrowing public as well as the lending institutions, while a fall in the Bank Rate serves as a green signal to them.

As a matter of fact, in a developed and well integrated banking system, it is an unwritten convention that the member bank should follow the lead given by the central bank of the country in the matter of lending rates. So whenever the Bank Rate in a country is raised, the member banks generally follow suit and raise their lending rates of interest accordingly. Similarly when the Bank Rate is lowered, the member banks follow suit by lowering their own lending rates appropriately.

(ii) Open-Market Operations

The second important traditional method of credit control at the disposal of central bank is the open market operations policy. Though, in the beginning, the central bank mainly relied upon the Bank Rate policy for controlling credit yet subsequent to the so called Keynesian revolution in economic theory, greater importance began to be

given to the open-market operations as a method of credit control.

Open market operation policy refers to the policy of central bank with regard to the buying and selling of eligible securities in the open market by it. In principle these securities can be government securities as well as non-government securities. But the general central banking practice is that they purchase and sell only government securities. The open-market operations, which, it is already observed, refer to the purchase and sale of securities by the central bank in the open money market, are generally confined to those individuals and institutions which deal in negotiable instruments. They comprise banks, business corporations, insurance companies, investment trusts, provident funds, pension funds and specialised financial intermediaries functioning on their own or on behalf of their client.

The mechanism of the working of this method of credit control is as follows. When it is considered desirable to check the expansion of credit to reduce its total volume in the economy, the central bank sells securities in the open market. The banks which buy these securities from the central bank have to pay cash to the central bank on account of which their cash reserves are reduced. The other institutions and individuals who purchase these securities from the central bank in the open market makes payments by drawing cheques on their banks and giving these cheques to the central bank. The central bank realises cash from the bank on which these cheques are drawn. Thus the cash reserves have now fallen below the minimum desirable. In order to maintain the minimum desirable cash reserves ratio in the interest of safety the banks will call back the loans advanced by them or will not renew them when the stipulated period of the loans expires. Thus the banking system is forced to destroy a part of the credit already created by it. The reduced cash reserves base will also discourage the bank from creation of fresh credit. Thus this particular open market policy, that is, the sale of securities in the open market by the central bank leads to decrease in the volume of bank credit.

On the other hand, when it is thought desirable in the interest of the national economic objectives to increase the volume of credit in the economy the central bank begins to purchase securities in the open market. The payment by the central bank for these securities purchased increase the cash reserves of the banks which enables the banks to create large amount of credit.

It should be noted that the open market operations of the central banks are intimately related with the interest rates and it can, therefore, influence the interest rate structure of the economy by manipulating its open market operations in an appropriate manner. For example if it wants to lower the long term rate of interest in relation to the short term rates it can do so by buying the long-dated securities and selling the short-dated securities. This operation will increase the prices of long

dated securities which implies a fall in the rate of yield from them; on the other hand, the market prices of short-dated securities will fall which implies an increase in the rate of yield from them. However, if all types of securities are purchased by the central bank in the open market their prices will tend to rise and since there is an inverse relation between the prices of securities and the rates of yield from them, all rates of interest will tend to fall. On the other hand, when the central bank sells securities of all types, the short-dated as well as the long dated, their prices fall and consequently the rates of interest yielded by them rise all round.

(iii) Variation in the Cash Reserve Ratio (CRR)

The method of varying the statutory cash reserve-ratio was evolved first of all in U. S. A. but now it is a well recognised general method of credit control. It is the general practice that the commercial banks are to keep by law a certain minimum proportion of their total deposits in the form of cash reserve with the central bank. The central banks are usually authorised by law to change this statutory ratio according to the needs of the circumstances. When the total value of credit is desired to be decreased or the rate of its expansion is required to be slowed down, this statutory cash reserve ratio is increased by the central bank. On the other hand, when the objective is to expand credit, this ratio is lowered. The principle underlying this policy weapon is that variation in the statutory cash reserve-ratio directly affects the cash reserves which remain with the bank and which form the basis on which bank credit is created. If the objective of the central bank is to decrease the volume or the rate of expansion of credit, it raises this minimum ratio. As a result of it, the banks have to keep a large proportion of their total cash reserves with the central bank. Thus a greater part of their cash reserves are immobilised and they have to create credit on a smaller base. In the reverse case when the objective is to expand credit, the statutory cash reserve-ratio is decreased. The banks have then, to keep a smaller amount of cash with central bank and a large amount of cash remains in their own reserves. This enables them to expand credit.

The Bank Rate policy and the open market operations also ultimately affects the cash reserve of the banks on which the superstructure of bank credit is based. But the virtue of this particular method is that it affects the cash reserves directly and more effectively.

(iv) Variation in the Secondary Reserve Requirements

It has now become a general practice for central banks to ask the member banks to maintain a minimum of secondary or supplementary reserves over and above the usual minimum legal cash reserve. These secondary reserves are generally to be kept by the commercial banks in the form of government securities. Statutory Liquidity Ratio (SLR) is the Indian government term for reserve requirement that commerical

banks in India are required to maintain in the form of government approved securities or gold, before providing credit to customers. This weapon was devised first of all in the USA in 1945 by the Board of Governors of the Federal Reserve System. The principle underlying it is that this additional requirement reduces the capacity of the commercial bank to convert government securities and surplus cash assets into business loans. This requirement can be raised when the objective is to check the expansion of credit while it can be lowered when the objective is to expand credit. A number of central banks such as those of India, Belgium, Mexico, Holland etc. have made use of this method of credit control.

(v) Regulation of Margin Requirements

The commercial banks, while advancing loans of their clients against securities or other stocks, insist on a certain margin of the total to be covered by the value of such securities or other stocks. The remaining part is supplied by the banks. The point is that the higher the margin requirement for such loans, the smaller will be the amount of bank loan available to the clients. Hence these requirements can be raised when the objective is to restrict and can be lowered when the objective is to expand credit.

This method too, was initiated and developed in the USA as a method of selective qualitative credit control. It can be used in a discriminatory manner by imposing different margin requirements in case of different types of loans. For example, if there is a speculative hoarding of food stocks with the help of bank credit with the result that food prices are rising sharply, the effect of which may spread to other prices also, the central bank of the country can ask the commercial banks to raise the margin requirement for loans given against the security of food grain stocks. The Reserve Bank of India, infact, has made use of this weapon to curb inflation arising from speculative hoarding of food grains. It can also be used to curb speculation in securities. In fact, when it was first introduced in 1934 in the USA, its motive was to curb speculation in securities market.

(vi) Rationing of Credit

A more direct method of credit control is rationing of credit by the central bank. This method is generally employed in inflationary situations when the total demand for credit is rising rather too high and is going far ahead of the available supply. The central bank, in such a situation, will fix quotas for each member bank as regards the financial accommodation which will be provided by it.

This is a method reported to have been employed first of all by the Bank of England as far back as towards the end of the eighteenth century, when it imposed a ceiling on its discounts available to banks. However as a systematic method of credit control, this method came into vogue mainly after the First World War.

The merit of this method is that it is possible to make qualitative use of it. It is particularly important in planned economies where rationing of credit is almost a logical corollary to the planned economic activity.

(vii) Regulation of Consumer Credit

This method refers to the regulation of the terms and conditions under which credit repayable in instalments can be advanced by the commercial banks. When it is desired to curtail the volume of credit, terms and conditions can be made more stringent, while in the opposite case these terms and conditions can be relaxed and made more liberal. This method is obviously more important in countries where the institution of hire-purchase of consumer durables is well established. It is, therefore, natural that this weapon of credit control was devised in the USA in 1941 during the Second World War for military uses.

This method aims at reducing the availability of bank credit for consumption as distinguished from production credit. Therefore, it is also a qualitative method of credit control. It can be very usefully employed in developing economies where the need is to restrict consumption and to encourage saving for capital formation.

(viii) Moral Suasion

This method refers to the policy of the central bank to advise and persuade the commercial banks to follow the credit policy which it formulates from time to time after taking into consideration the current economic and monetary situation in the country and the economic interests of the country. Since the central bank is generally accepted as the leader of the banking system, it is always possible for it to send out guidelines to the member banks and to advise them to follow a particular course in their credit lending operations. This method is particularly important in countries where the central bank is hardly in a position to undertake open market operations. This method has been employed with varying degrees of success in countries like the U. K., France, Sweden and Holland as well as by the relatively new central banks of countries like India, Australia, New Zealand and Canada.

(ix) Direct Action

The method of direct action by the central bank refers to the punitive measures to which it can resort, to make the defaulting member banks to fall in line and to execute the lending policy as advised by the central bank from time to time. These punitive measures may take the form of refusal of rediscount and other facilities to the erring banks by the central bank. It is obvious that this method is complementary to the method of moral suasion. Moral suasion is the first step which, if it fails has to be followed by direct action by the central bank. Therefore, there is some substance in the view of those economists who look upon moral suasion as a part of direct action and do not distinguish between the two.

EFFECTIVENESS OF METHODS OF CREDIT CONTROL

We have above merely described the different methods which the central bank of a country can adopt in order to control the volume of credit and its use. But it is yet to be seen as to how far they can be effective in their operations. In this regard, it may be noted at the very outset that none of these methods is fully effective in controlling credit though almost each one of them can be made more effective if it is supplemented with some other appropriate method. This point will come out from the following discussion of the e**ffectiveness of each of the methods of credit control** that we have described above.

We may start with the **Bank Rate Policy**. Bank Rate Policy can be effective only if the member banks follow the lead given by the central bank. If, for example, the Bank Rate is revised by the central bank in order to restrict the expansion of bank credit but the commercial banks do not follow suit with regard to their own lending rates, the desired objective will not be obtained. The commercial banks may refuse to raise their rates, because they might be in possession of enough surplus funds over and above the minimum necessary reserves so that they do not have to approach the central bank in order to carry on their lending operation. In the reverse case when the central bank lowers the Bank Rate in order to expand credit, the member banks may not expand their credit. They may, instead, use their surplus funds to pay back the loans taken from the central bank. Moreover, in this particular case there is a minimum rate of interest below which the commercial bank rate of interest cannot fall because it will fail to cover even the operational costs of lending business done by the commercial bank. In addition, if the commercial banks do not habitually rediscount or borrow funds otherwise from the central bank any change in the Bank Rate will have hardly any effect on the rates charged on the commercial bank loans. During periods of depression when businessmen are naturally pessimistic with regard to the rates of return on investments, the credit will not expand even when the commercial banks lower their rates following the lead given by the central bank. For if borrowers are not coming forward to borrow from the banks due to pessimistic business expectations, the banks will fail to expand their credit in spite of the lowering of the commercial bank rates. As Crowther has observed one can take a horse to the water but cannot make it drink.

If the Bank Rate is to be made effective, the following conditions shall have to be satisfied. The banks should be, as a usual practice, rediscounting bills with and borrowing funds from the central bank. It should not be merely an emergency practice. This, in turn, requires the following four conditions as enumerated by S. N. Sen in his book *Central banking* in *Under developed Money Markets:* (i) Commercial banks should not be prejudiced against the practice of rediscounting with the central bank (ii) they should be in the habit of keeping with themselves cash reserves which are just sufficient to

carry on their business, that is, they should not have surplus cash in their reserves; (iii) they should be possessing adequate amount of bills which are eligible for rediscounting with the central bank and (iv) the demand for bank loans should be substantial.

The last condition mentioned above implies that if other conditions are satisfied, there are great chances of this policy becoming effective in booms when the objective is to restrict credit than in depression when the demand for bank advances is very low and the objective of the Bank Rate Policy is to expand it. The second condition listed above, on the other hand implies that this policy can be more effective if it is used along with the open market operations than if it is used in isolation. For if the banks have surplus funds in their cash reserves which induces them not to raise their rates even when the Bank Rate has been raised, the central bank can mop up these surpluses by selling securities in the open market. Similarly if the banks are unwilling to lower their rates and expand their credit during depressions because they do not possess enough reserves the Bank Rate Policy will not be quite effective unless it is supported by an appropriate open market operations policy and/or variation in statutory minimum reserve policy in order to increase their cash reserves.

The **open market operation policy** may also not prove effective. During booms when the objective is to reduce the volume of credit or to apply brake on its rate of growth, the central bank does it by selling securities in the open market which has the effect of reducing the cash reserves of the commercial banks. With cash reserves, which form the base of the bank credit, so reduced, the banks are expected, in the theory of open market operations, to reduce their advances. But if these banks enjoy the facilities of rediscounting with the central bank, they can easily replenish their depleted cash reserves by borrowing funds from the central bank. In periods of depression when the objective is to expand credit, the central bank tries to increase the cash reserves of the banks by purchasing securities in the open market and injecting cash into the reserves of the banks by way of payments against these purchases. But the banks may use this surplus inflow into their cash reserves; certainly be so, if the businessmen, due to their pessimistic expectations, are not coming forward to borrow from the banks. In addition to it, the very policy of open market operations will become difficult to operate if there does not exist in the country a broad and active market in government securities, otherwise, the open market operations policy may lead to wide fluctuations in the market operations of the central bank. The central bank may, then have to purchase securities at very high prices and sell them at very low prices which may make the operations of this policy forbiddingly expensive. If the securities market is so under-developed that there are not enough securities to operate with, the policy of open market operations cannot be effective.

As regards reducing the volume or the rate of growth of credit, the open market operations stand better chances of meeting with success when they are combined with Bank Rate Policy than when they are employed to that end in isolation. It is because when the central bank sells securities in order to reduce the cash reserve of the member banks, they will not try to replenish them by rediscounting the securities and other bills with central bank if the bank rate is also raised simultaneously with the sale of securities in the open market. In depressions too, unless they are deep rooted in very adverse business expectations, the policy may prove to be more effective if purchase of securities in the open market is accompanied by a fall in the Bank Rate.

It may be thought that the policy of **varying the statutory minimum reserves** to be kept by the member banks with the central bank may prove to be more effective; first because it is a more direct method than the open market operations. If the objective is to reduce or expand the cash reserves of the member banks which is the base of the superstructure market, this method will prove to be an inexpensive substitute of the open market operations policy. But as a matter of fact, the effectiveness of this policy, also depends on the fulfilment of certain conditions, some of which are as follows :

(i) The member bank must be following the policy of lending on the basis of their cash reserves.

(ii) The bank must also be following the practice of maintaining a fixed ratio between their deposit and cash balances; and

(iii) Banks should not be in a position to counter attack the effect of this central banking policy of cash balance through a reshuffling of their assets and liabilities. It is contended that banks do not base their lending operations on their cash balances alone, they may, on the other hand, attach more importance to their foreign funds and/or the ratio of their advances to their deposits. Moreover, the banks do not necessarily follow the practice of maintaining a fixed ratio between their deposits and cash balances. In the event of central bank raising the statutory minimum reserve to be kept with it the member banks may decide to operate with a lower deposit cash balances ratio. The policy, obviously, will not be effective to that extent. Similarly, if the banks are in position, as they generally are to convert some of their assets into cash and vice versa, any intended effect on the cash reserves of the member banks through this policy can be suitably foiled by such conversions.

Without repeating the whole argument, it can be said of this policy that it will be more effective if it is combined with the Bank Rate policy than if it is employed in isolation.

These quantitative methods of credit control suffer, in addition to the limitations already mentioned above, from the further limitation that they, even when effective, can

only control the volume of credit but cannot control the direction of its use. Some monetary maladies may require a qualitative control of credit rather than a more quantitative control. Therefore, in order to make the above mentioned main weapons of credit control more effective it would be necessary to combine them with appropriate qualitative methods of control according to demand of a particular situation. These qualitative methods have already been described in the preceding section as rationing of credit, regulation of required margins, regulation of consumer credit, moral suasion and direct action. Nevertheless, it should be noted that all these methods, even when combined together, may not be adequately effective in deep depression. When there is crisis, they will become effective if combined with a proper fiscal policy.

CENTRAL BANKING IN DEVELOPING COUNTRIES

Though the basic theory and practice of central banking in the developing countries is the same as that in the developed countries, yet there are certain differences which must be carefully noted. The theory and practice of central banking is similar but not identical with that in the developed countries. These differences are despite the underlying similarity due to the differences in the state of their economic development as well as in relative importance attached to the various policy objectives.

In the first place, as we observed in the preceding lesson, while in the developed countries like U. K., the U.S.A. and others, the regulation of the monetary and banking system in the country with a view to maintaining internal and external stability of the economic system, is more or less the sole objective of the central banks, in the underdeveloped and developing countries, developmental functions of central banks are as much, if not more important as the regulatory functions. In the advanced countries the central banks were established at a time when their economies had already attained a fair level of economic development and the development goals were not the express concern of either their government or government sponsored institutions. Consequently the development functions were not given an explicit recognition in the traditional theory and practice of central banking. Moreover, these central banks were established when the money market of these countries had also fairly developed so that the traditional techniques of central banking operation could be effective there. Developing the national money market was naturally not an express function of central banks of these countries. Although in the charters of the central banks of some underdeveloped countries which were established during the inter-war period and which had been modelled after the central banks of the advanced countries, the main importance had still been assigned to the regulatory functions, yet the emphasis changed after the end of the Second World War, when rapid economic development of the underdeveloped countries became the immediate and main goals of the state policy in these countries. Hence the development functions, which aim at developing the money market in the banking system rapidly and thus aim at bringing about a rapid economic development, have

come to acquire a much greater importance in the theory and practice of central banking in the underdeveloped countries. This, however, does not imply the abandonment of the regulatory functions. The importance attached to the development function of central banks in the developing countries has naturally led to the abandoning of the traditional principle of central banking in these countries according to which the central banks were required not to directly participate in the financing of industry and agriculture and other economic activities. In developing countries there are economic activities which are crucial to the rapid development of the national economy.

Thus, it can be said that central banks in the developing countries have come to play the role of an agency of development rather than that of an agency of mere regulation.

Secondly, in so far as the central banks of under-developed and developing countries have to function in under developed money markets, the traditional techniques of monetary control as they have been applied in the developed countries, may not be very effective. The Bank Rate policy as well as the open market operations policy cannot be of much use by themselves : the Bank Rate Policy may be ineffective due to the lack of an integrated money market which is dualistic in nature, comprised as it is of the organised and an unorganised sector and in which the latter sector, which is not amendable to central bank control, predominates. The open market operations policy is unworkable effectively because of the lack of wide and active securities market. In consequence of it, the central banks in developing countries have to put their main reliance on the techniques of variable reserve ratios for the purpose of credit. Moreover, in the developing economies, structural imbalances are endemic which lead to shortages in strategic industries and sectors which generally leads to speculative hoarding of specific commodities with the help of bank credit. Such speculation and misuse of bank credit is sure to lead to distortions in the economy, hindering the rapid development of the economy. Therefore, in order to avoid this malady it is imperative for the central banks of the developing countries to make greater use of the methods of selective credit control and thus to divert bank credit away from the undesirable industries and activities to the desirable ones.

An obvious merit of the selective controls is that their effectiveness, unlike that of the traditional quantitative methods like the Bank Rate and the open market operations, does not depend on the development of the market.

Note : Suggested Readings are the same as L. No. 1

Questions for Practice

1. Discuss the quantitative methods of credit control
2. Discuss the instruments of monetary management of a central bank. Discuss the effectiveness of these instruments
3. Write short notes on: (i) Moral suasion (ii) Open market operations (iii) Bank rate (iv) Cash Reserve Ratio.

LESSON NO. 1.3

MONETARY POLICY-I

In the present and the next lesson we shall be dealing with various aspects of a particular variant of macro economic policy, namely the monetary policy. We propose first to clarify the concept of monetary policy and then to discuss the objectives of monetary policy, the instruments of monetary policy and the effectiveness of monetary policy.

THE CONCEPT OF MONETARY POLICY

The traditional interpretation of the term monetary policy is that it refers to that policy of the monetary authority of a country (which is normally the central bank of the country concerned) which aims at altering the supply of money in order to vary the rate of interest. However, the interpretation of the concept of monetary policy is not very satisfactory. For one thing, in modern economies there is not one rate of interest but a structure of interest rates. And this definition does not specify the rate of interest which is supposed to be the target that is to be varied through a change in the supply of money. Secondly, the definition conveys a misleading notion that varying the rate of interest is, as it were, the object of monetary policy while in fact, it is only an instrument to attain the objective of varying the aggregate expenditure in the economy.

Friedman, the apostle of modern monetarism, goes to a still greater extreme by identifying monetary policy with only such measures of the monetary authority which aim at changing the money stock in the economy. He explicitly demarcates it from the credit policy which may aim at varying the interest rates. However relevant this particular concept of monetary policy may be within the framework of Friedman's own monetarism, the fact is that the concept of monetary policy as it is usually employed in economic analysis and discussions is broader than Friedman's concept of it and includes with it not only the measures adopted by the monetary authority to influence the stock of money but also measures adopted by it to influence the level and structure of interest rates with a view to influence the level of aggregate expenditure and/or the structure of that expenditure.

In view of the above discussion, it should be more appropriate to define monetary policy as referring to those measures of the monetary authority which aim at influencing the level of aggregate spending in the economy through variations in the level and structure and interest rates or through changing the liquidity position of the economy. It should be noted that this way of interpreting the concept of monetary

policy does not rule out or even minimize the importance of the supply or stock of money, for the liquidity of the economy ultimately depends upon the level of cash reserves of the banks and non-bank financial institutions which in turn, depend on the total supply of money in the economy. The monetary policy helps in the healthy growth of the economy of the country by adjusting money supply to the needs of growth, by directing the flow of funds to the required channels and by providing institutional facilities for credit in some specific field of the economy. The primary task of the monetary policy is the mobilisation of resources to the proper channels.

OBJECTIVES/GOALS

There can be various objectives of monetary policy but broadly speaking it may have one or more of the following main objectives. In modern developed economies perhaps the first and foremost objective of monetary policy is the attaining of full or nearly full employment of the productive equipment and labour force of the society. Another objective may be to maintain the stability of domestic price level. Achieving a targeted rate of growth in the national income and per capita income is another possible objective of monetary policy. Still another objective may be the attainment and maintenance of equilibrium in the balance of payments of the country which would tend at maintaining the stability of the foreign exchange rate of the national currency. Apart from the above mentioned objectives the monetary policy may also aim at balanced regional development within the country and can even help to change the distribution in a particular manner through fiscal policy rather than monetary. It is also possible that monetary policy may be employed to change the structure of investment within the economy.

Although there are various possibilities as regards the objectives of monetary policy yet the more important objectives are generally :

(i) The attainment of full employment:
(ii) The attainment of a stable domestic price level:
(iii) The attainment of a satisfactory rate of growth, and
(iv) The attainment of equilibrium in the balance of payments and thus attaining the stability of the foreign exchange rate.

As A. D. Bains has observed, "In the short run these are all seen as objectives, but in the long run price stability and balance in foreign payments are usually regarded as constraints which influence the extent to which other objectives can be achieved rather than as objectives in themselves, for most governments are in fact willing to allow a moderate price inflation if this permits to achieve other objectives."

It has to be noted that all the main objectives of monetary policy mentioned above need not always be mutually inconsistent, that is, the attainment of any one objective need not always exclude the attainment of all other objectives. On the other

hand, there is a strong reason to assume that the attainment of some of these objectives would rather automatically ensure the attainment of some other objective(s). For example, if the monetary policy succeeds in attaining full employment and maintaining it overtime, it should automatically ensure the attainment of the objective of growth; the attainment of a stable domestic price level may also ensure or at least facilitate the attainment of the growth objective. Nevertheless it does in no way imply that there is no conflict between the various objectives of monetary policy. The conflict between the objective of price stability and that of exchange rate stability has been quite famous or notorious. The conflict between the full employment objective, on the one hand, and the price stability on the other has also been widely noted as is evident from the dilemma model of inflation which has been forcefully highlighted in the Phillip's curve. As a matter of fact, perfect stability of prices, as implied in hypothesis of Phillip's curve may lead to high degree of unemployment and thus endanger the attainment of both the full employment objectives and the growth objective. Therefore, though in some cases the attainment of one particular objective may also ensure the attainment of some other objective, yet all the major objectives of monetary policy are not positively correlated.

If the various objectives are not positively correlated so that the attainment of any of these does not necessarily ensure the attainment of all others, choice of objective has to be made. However, this choice is generally made through political process and the monetary authority simply fashions its policy to facilitate the attainment of the objective which has been determined politically. But political determinations of the choice of objective(s) does not imply that the political processes do not pay heed to economic consideration.

Internal Versus External Stability (Stable Domestic Price level vs. Stable exchange rate of currency)

Before the Second World War, particularly during the thirties of the present century most of the debate regarding the objectives of monetary policy centred around the problem of *internal* versus *external stability* that is whether the desirable policy should be the stabilising of the domestic price level or the stabilisation of the exchange rate of the national currency. So long as the countries of the world were on the gold standard, the rate of exchange between different national currencies was practically fixed by the *mintpar* of exchange and it could fluctuate, in a free market environment only within very narrow limits known as the *specie* point which were determined by the cost of transporting gold between the countries. But when in the wake of the Great Depression of 1930s the countries began, first to say good bye to the rules of the Gold Standard and then, to say good bye to the Gold Standard itself, the controversy between the proponents of *internal* stability on one side and the advocates of *external*

stability, on the other side, became very sharp.

The main arguments which can be given in favour of *external stability* as the goal of monetary policy are as follows. The most important argument in favour of this objective is that a stable exchange rate encourages international trade. By providing widening markets the internal trade tends to expand economic activity in all the countries which ultimately leads to higher standards of living. If the foreign exchange rates are unstable and fluctuate freely, it reacts uncertainly and discourages international transactions, thus narrowing the scope of world trade and consequently keeping the standards of living at relatively lower levels. Secondly, fluctuating exchange rates also distrupt financial relations between countries with adverse effects on the growth of their economies. Thirdly, a situation of fluctuating exchange rates is also a breeding ground for speculation which distort the pattern of economic activity as well as hampers international credit operations of the normal kind. In fact, it may lead to flight of capital to other countries whose foreign exchange rates are stable. The flight of capital out of a country may cause a serious crisis in the national economy. It may deplete the foreign exchange reserves of the country and thus render the imports of essential goods very difficult. If these inputs happen to be essential industrial inputs, their shortage will cripple the economy.

The most important argument advanced against the external stability goal is that it subordinates the national economy to the interests of world trade. Moreover, the stability of foreign exchange rate may cause wide-spread unemployment of men and other productive resources under certain circumstances. In such situations sticking to fixed exchange rate may prove disastrous for the national economy. Moreover, when there is a fundamental disequilibrium in the balance of payments position of a country, it cannot be corrected by means other than a change in the foreign exchange rate. Moreover, as J. M. Keynes has pointed out in his *Tract on Monetary Reform,* fixity of exchange rates throws the whole burden of adjustment on the internal prices when important changes are taking place in the outside world. Apart from the fact that fluctuating domestic price level has harmful effects on both production and distribution, many important domestic prices in a modern economy are not flexible. For example, wage rate in a modern economy with strong trade unions cannot be lowered in order to reduce the costs and prices. Lastly, fixed exchange rate renders the country helpless against inflationary and deflationary tendencies in foreign countries.

The arguments in favour of domestic price stability focus on the harmful effects which rising or falling prices have on both production and distribution. A falling price level depresses income of entrepreneurs. In fact, a persistently falling price level may cause losses all round which will lead to heavy cutbacks on investment.

This, in turn, will reduce employment and cause large unutilised production capacity. Widespread unemployment and low level of the incomes spread misery, discontent and resentment which may have dire social and political consequences. On the other hand, rising prices may some times have wholesome effect on production and employment for rising prices usually lead to rising business profits which encourages investment that generates increasing employment and output. But a persistently rising price level makes speculation more profitable and less bothersome than production, thenceforth, a rising price level has little favourable effect on production. It has obviously a very harmful effect on distribution for it reduces the real income of the working and salaried classes as well as of other fixed income classes while the income of the business community goes on rising rather steeply. This makes the distribution more and more unequal with very grave social and political consequences. Hence it is argued that the domestic prices should be stabilised and whenever there is a conflict between the goals of *internal and external stability,* the former goal should be preferred to the latter. This policy choice is specially recommended for larger countries with extensive domestic market.

However, now-a-days *internal* stability is not interpreted in the narrow sense of the stability of the internal price level. On the other hand, it is now interpreted to mean stabilisation of the economic activity at the full or nearly full employment level so that there are no inflationary pressures in the economy. As we have already observed, while quoting A. D. Bain above, price stability and exchange rate stability are now regarded more as constraints within which some objectives are to be attained rather than as objectives in themselves. The other, more desirable, objectives of monetary policy are now (i) attainment of full employment with price stability in the short run so that cyclical fluctuations are removed, and (ii) attainment of a desired rate of growth of the economy over the long period.

Targets of Monetary Policy :

In simple words, targets are proxy variables for goal variables. These are needed because in order to influence the goal variables in desired directions and degrees, the monetary authority would like to know the impact of its policy actions on the goal variables. Because of uncertainty, these effects are not only delayed and distributed over time, the underlying lag structure and its determinants are also not known reliably. Then there are information gaps regarding real income and employment. Further, the goal variables are affected both by policy measures and non-policy developments. All these information gaps require the use of some variables to be used as proxies for goal variables and use them as their immediate policy targets to guide policy steps.

Thus, targets can be defined as endogenous variables which the monetary authority tries to control or influence so as to influence the goal variables in the desired manner. A target variable should possesss the following qualifications :

(i) It should be closely related to goal variables and this relation should be reliably estimable;
(ii) it should be rapidly affected by policy instruments;
(iii) non-policy influences on it should be small;
(iv) it should be rapidly observable and measurable with little or no time lag.

There are three variables which have traditionally served as candidates for monetary policy targets - money supply, bank credit and interest rates in securities market. All three satisfy condition (iv) equally well; both money supply and bank credit meet conditions (ii) and (iii) equally well; it is money supply alone that meets condition (i) well. This is so because market rates of interest are heavily affected by non-policy factors, and are not rapidly affected by policy instruments. Also, theory as well as empirical evidence in support of the close causal link between bank credit and the level of economic activity are rather weak. Thus, money supply scores over bank credit as a target variable.

Indicators of Monetary Policy :

A monetary policy indicator is needed to measure correctly the intensity of policy actions so that by looking at it we can know how much of a change in the target variable already chosen is due to policy actions. This will help in evaluating and readjusting policy actions quickly. An ideal indicator, thus, would be one which is influenced only by policy actions.

The commonly used indicators are :
(i) high powered money (adjusted)
(ii) money supply
(iii) bank credit
(iv) interest rates,

Of these, the adjusted high powered money (H*) is the best indicator. Money supply, although, normally chosen as the best target, is inferior to H* because the money multiplier which links money supply to high-powered money is largely an endogenous variable subject to non-policy influences of various kinds. Even if H*is not totally policy determined (as we have already studied in the H theory of money supply), changes in it are much more within the control sphere of the monetary authority. In this sense H* is better than all other monetary indicators.

INSTRUMENTS OF MONETARY POLICY**

Basically there are two target variables which a monetary policy seeks to influence through its instruments. These target variables are the interest rates and supply of the money which determine the liquidity of the money market.

** These instruments have been discussed in detail in a previous lesson on Central Banking also, because the Central Bank is the implementing authority of monetary policy.

The instruments of monetary policy through which these target variables are sought to be influenced in order to achieve the pre-determined objectives may broadly be classified into two categories—the *general* instruments and the *specific or selective* instruments. The general instruments of monetary control aim at changing the general rate of interest and the liquidity of the money market so as to change the total volume of credit in the economy in the desired direction. The specific selective instruments of monetary control on the other hand aim at changing the *pattern* rather than the *volume* of credit in the economy.

In general, instruments of monetary policy are mainly the **Bank Rate or the Discount Rate, Open Market Operations and Variations in the Statutory Reserves of the Banks.**

We may explain the working of these instruments in the context of the objective of stability.

A change in the short-term rate of interest can be brought about by changing the **bank rate**, that is the rate at which the central bank of a country discounts the first class short term bills of exchange like the treasury bills. A change in this rate usually has a direct effect on the rate of interest charged by the commercial banks on their short-term advances as well as other short-term rates, such as those charged for money at call, bills discounted, hire-purchase finance etc. This is specially so in countries where there is well developed and integrated money market. The rationale underlying the use of this instrument is that the commercial banks have usually to approach the central bank whenever they are short of funds, for the latter is the lender of the last resort. If the Bank Rate is increased, the commercial banks can get funds from the central bank at a higher rate of interest. Consequently they are also expected to raise their own rates. This will not only make credit more costly but will also eventually reduce the demand for, and in consequence there of, the supply of bank credit. When it is desired by the monetary authority to increase the volume of credit, the bank rate is lowered which is expected to cause a decrease in the rates of interest charged by the commercial banks. The decrease in rates is expected to stimulate the demand for and supply of bank credit.

The above argument is applicable to the long term rate also with the only difference that the bank rate in this case refers to the rate at which the central bank discounts the long term bills.

The instrument of bank rate policy may not always be effective. In the first place it could be effective only if the demand for bank credit was interest elastic, while in fact, it may not be so. For instance the short-term rate is generally relevant to investment in

inventories. But a change in this rate is not likely to influence it significantly because interest cost makes a small part of total costs. "Similarly, a rise in this rate may not discourage consumption credit which is generally facilitated by the hire-purchase system, for interest charges generally make up a small fraction for the total instalment payment. Even otherwise the rise in this rate is not likely to discourage consumption and encourage saving significantly, for in modern societies most of the savings are done contractually in the form of provident-fund contributions and insurance premia which are not influenced by changes in the short-term rate of interest. Further limitations of the short-term rate of interest as an instrument of monetary control may arise from the following facts; (i) A rise in the rate may cause or aggravate balance of payments problem by increasing the cost of short term borrowing from abroad and a fall in this rate may encourage the flight of short-term funds to other countries. This may cause or aggravate the balance of payment problem. (ii) A rise in this rate may cause a rise in the long term rate, for people may begin to expect a rise in the long term rate of interest also and therefore a fall in the price of long term bills, so they will begin to sell these bills when their prices are still high, but this rush for selling will surely depress their prices which will lower the rate of their yield or the long-term rate. If the monetary policy assigns some importance to these factors, the effectiveness of this instrument will be limited.

The long term rate of interest is relevant to the long-term investment. Changes in it are assumed to influence the expenditure on long-term investments in fixed capital and consequently the demand for long term credit. But in the case of the long term rate of interest also, the effectiveness of the instrument depends on the interest elasticity of demand for long term credit. We have the Keynesian hypothesis according to which investment is relatively interest inelastic which reduces the effectiveness of this instrument in influencing the investment expenditure in the economy. Moreover, if the rate of interest is already at the critical minimum rate at which, according to the liquidity trap hypothesis, the demand for money becomes perfectly elastic, it will not be possible to reduce it further. In such situations the instrument of bank rate becomes impracticable. Thus this instrument is of little use for correcting deep depressions of an economy. Its effectiveness in periods of even boom is also questioned for the profit expectations being very optimistic in such periods, practicable increases in the rate of interest do not significantly discourage borrowing for investment. In addition to these limitations, this instrument is further constrained if the member banks do not follow the lead given by the central bank. They may not raise their own rates when the bank rate is increased because they might be having some surplus cash reserves to expand credit without having to take recourse to the central bank.

The last point mentioned in the preceding paragraph underlines the importance of controlling the liquidity of the banking system in a scheme of monetary control.

Moreover, operating the instrument of interest rate is likely to result in *excess demand* for *excess supply* of funds when at the pegged rate of interest the demand and supply of funds do not balance. Therefore, it becomes necessary to control the liquidity of the banking system and even the credit system as a whole. There are two important instruments which can be employed to that end, namely, the **open market operations** and variations in Statutory Cash Reserves of the banks. When the banking system is having more liquidity than is desirable from the point of view of the objective of monetary policy, the excess liquidity can be mopped up by the monetary authority through the sale of securities in the open market. The banks buying these securities will have to pay cash for it. The individuals and firms buying these securities will pay by drawing cheques on their banks. This will reduce the cash reserves of the banks compelling them to reduce their volume of credit and even to raise the rate of interest. The reserve operation of buying securities in the open market can be adopted by the monetary authority with a view to increasing the liquidity of the banking system and consequently the ability of the banking system to create credit.

However, the effectiveness of even this instrument will be limited specially if it is not supplemented with the interest rate policy. For, when the central bank is buying securities in order to reduce liquidity, the commercial bank may replenish their reserves by borrowing from it. In the reverse case the increased cash reserve due to the purchase of securities by the central bank may be utilised by the bank. Thus, though the liquidity of the banking system can be influenced it does in no way ensure that the volume of bank credit will also change accordingly.

Similar is the case with the other instrument aimed at influencing the liquidity of the banking system. This instrument is **variations in statutory cash reserve** which the member banks are required to keep with the central bank of the country. When it is desired to decrease the liquidity, this ratio is raised. In the latter case, the banks are left with smaller cash reserves on which to create credit while in the former case they find their cash reserves increased enabling them to expand their credit. But supply of bank credit will not automatically change according to the change brought about in their cash reserves through this instrument. For, in this case increased cash reserves may be used to repay the earlier loans taken from the central bank and depleted cash reserves may be replenished through borrowing from the central bank.

As regards the limitation of these instruments arising from the possibility of banks borrowing from the central bank to replenish their depleted cash reserves, the loophole can be plugged by another instrument, namely, ***rationing of credit.*** The central bank may fix the maximum limit upto which a member bank can borrow from it. In addition to it central bank can also raise its lending rate to the member banks. On the whole, these various instruments are likely to prove more effective when they are

applied in unison than when they are applied in isolation from one another. Apart from overall quantitative controls, **selective controls** can also be used. They can be applied to influence specific sectors in the economy in order to control excessive credit demands in particular directions. The central bank can also take recourse to moral suasion.

Effectiveness of Monetary Policy

In the preceding section we described and explained the working of the various instruments of monetary control. During the course of this explanation we also referred to some of the limitations of the various instruments of monetary control, on account of which their effectiveness and consequently the effectiveness of the monetary policy in general is also undermined. In addition to these limitations, there are a number of other considerations too on account of which the monetary policy may not prove to be quite effective.

The monetary policy, in so far as it operates through a change in the supply of money with a view to changing the rates of interest in the desired direction may be effective, when the investment and the consumption expenditures, particularly the former are not interest elastic or when this elasticity is very low. While some of the empirical studies do show that the investment is not interest inelasitc, they nevertheless, also show this elasticity is much lower than what it was supposed to be by the classical economists. This does not provide ground to believe in the effectiveness of the monetary policy.

Moreover, in so far as investment expenditure, which is more volatile than the consumption expenditure, is influenced more by business expectations than by the rate of interest, monetary policy may prove to be ineffective not only in periods of depression, but also in boom, even though it is generally believed that it is likely to be more effective in booms than in depression. In depression it proves ineffective because of the liquidity traps as well as the pessimistic business expectations on account of which the investment expenditure does not pick up in spite of the low rates of interest. During booms rising investment expenditure cannot be controlled through the monetary policy due mainly to two reasons. Firstly optimistic business expectations may shift the marginal efficiency of capital schedule to such an extent that no reasonable and practicable increase in the rate of interest can substantially discourage the investment expenditure. Secondly, the modern economies have evolved various types of non-banking financial institutions (NBFI) which provide funds for investment and consumption expenditures when these funds are made difficult to get from the banking system through the monetary policy. At present these NBFI are, generally speaking, beyond the scope of monetary policy of the central bank.

In addition, in modern economies there is a very substantial portion of the national

expenditure which is incurred by the government which is not at all sensitive to changes in the rates of interest. This further reduces effectiveness of the monetary policy.

Lastly, there is the problem of timing. It is very important that the desired monetary policy is put into practice at the right time, otherwise, it may prove to be an aggravating factor as regards the instability of the economic system instead of proving to be a stabilising factor. It is because of the fact that the effects of any monetary measure in the dynamic world can show only with time lag. If the rate of interest is raised at such a rate that its effect is felt when an economy is entering into recession, the monetary policy instead of stabilising the economic activity at near full employment is likely to push on a downward course.

In conclusion it can be said that the monetary policy by itself cannot be sufficiently effective in the real world economies. It has to be combined with fiscal policy in a judicious manner in order to be effective.

Monetary Transmission Mechanism :

The monetary transmission mechanism refers to the process through which changes in monetary policy instruments affect the rest of the economy and, in particular, output and inflation. Moneary policy impulses transmit through various channels, affecting different variables and different markets, and at various speeds and intensites. It is important to have a broad understanding of these channels. Discussed below is a brief description of four different channels of transmission. These channels can and do operate simultaneously, but their influence varies across countries and over time.

1) Quantity Theory Mechanism : The Quantity Theory of Money (QTM) explained the mechanism by emphasising that when money (as general purchasing power) increases, it will flow into all other non-money markets and push upward the demand for both bonds and goods and services. Thus, a link was seen between the markets for bonds, money and commodities, but it was a loose link. Fisher's version of the quantity theory of money was simple, giving a direct relation between money and prices. The Cambridge Quantity Theory of Money hinted towards a transmission mechanism by refering to adjustments made between the actual and desired stocks of money through changes in flows of expenditure. Keynes substituted this direct transmission mechanism with an indirect transmission mechanism by introducing the rate of interest. It was Friedman's Modern Quantity Theory of Money which widened the narrow Keynesian interest rate mechanism by widening the range of substitution between money and non-money assets to include real physical goods along with financial assets.

2) The Real Balance Effect Mechanism: The real balance effect, introduced by Pigou, referes to the effect which a change in the value of real cash-balances held by the public produces in the economy. Real balances are defined as M/P, where M is

outside money- a liability of the government but asset of the holding public. Thus M/P is a part of the real net wealth of the public. This means that any change in it will produce wealth effect. In particular, it will affect consumption-savings of the public. If M/P goes up, other things being the same, households are wealthier than before and they will be induced to consume more (i.e. save less) out of the given level of real income. The reverse will happen if M/P goes down. The real balance effect of a change in M explains why a change in M affects expenditure, income and prices.

3) The Interest Rate Mechanism: We have already studied this mechanism in the lesson on Keynes' theory of money and prices (in the previous semester). The key point emphasized by Keynes was that money influences commodity market not directly (as stressed by the Quantity Theory of Money), but indirectly through the bond rate of interest.

4) Credit-Availibility Mechanism: This mechanism emphasizes the availibility of credit to deficit spenders as an important channel of transmission of monetary influence to the commodity market. When the availibility (supply) of credit is increased, the financial resource constraint on deficit spending is relaxed. We also know that increase in quantity of money is accompanied by an increase in bank credit. Further, a certain part of the aggregate expenditure is credit financed spending and is thus influenced positively by the availibility of credit.

Suggested Readings

1. Suraj B. Gupta : Monetary Economics. Theory Institutions and Policy.
2. Parminder Khanna : Advanced Study in Money and Banking (Vols I and II)

Questions for Practice

1. Define monetary policy. Discuss goals of monetary policy.
2. Examine the instruments of monetary policy.
3. Write short notes on: (i) Targets of monetary policy (ii) Indicators of monetary policy

MONETARY POLICY-II

In the present lesson we shall first deal with the role of monetary policy and, after that with the monetary policy in India.

ROLE OF MONETARY POLICY

The views on the role that the monetary policy should play in the management of economy have been changing from time to time, depending upon the understanding of the nature of the economic problem which the economies of various countries had to face at particular junctures of time. These views have differed with time with regard to the role of monetary policy in the advanced economies. Moreover, in the post-war period, the preoccupation with the problem of accelerating economic development in the underdeveloped or the developing economies of the world has led to the realisation that role of monetary policy in the less developed countries need not be the same as in the context of the developed economies and, later on, shall discuss its role in the context of the developing countries.

Before the Second World War the only role which was assigned to the monetary policy in the developed economies of the world was to iron out the cyclical fluctuations in economic activity. The role of monetary policy was conceived to attempt at 'fine tuning' the economy which implied that the monetary policy should be employed in such a manner that the credit conditions are relaxed and the interest rates are lowered in recessions in order to prevent them from developing into depressions, and the credit conditions are tightened and interest rates are raised in boom in order to prevent them from developing into situations of uncontrollable inflation. In other words, the role of monetary policy was believed to be mainly of stabilizing the economic activity and the price level.

The debate on the monetary policy during the pre-war period centred on another issue too. This issue, to be precise, was whether the monetary policy should aim at stabilising the internal price level or stabilising the external value, that is the foreign exchanges of the national currency. Normally there should not be any conflict between the two objectives, for once the real variables of an economy have adjusted to the rest of the world, a monetary policy which succeeds in stabilizing the domestic price level should also at the same time aim to achieve the stability of the external value of the national currency. But conflict could

arise as a consequence of some fundamental change taking place in some real factor or factors, either at home or abroad. For such a fundamental change could significantly disturb the balance of payments positions of countries. In such situations it becomes necessary to choose between internal stability and external stability of the value of the national currency. Under the Gold Standard regime (which was widely prevalent before the Great Depression of the 1930s that knocked it out) the stability of foreign exchange rate was given precedence over the stability of the internal price level. The role of monetary policy within the frame work of the Gold Standard was believed to observe the "rules of the game" that the Gold Standard was. These "rules of game" required that there should be no restrictions on the movement of gold from and to a country. Secondly they also required that the monetary authority of country should increase the supply of money and lower the interest rate when there is an inflow of gold, and it should reduce the supply of money and raise the interest rate when there was an outflow of gold. The inflow of gold resulted from a favourable balance of payments position. In consequence of these "rules of game" the exchange rate fluctuated insignificantly around the mint par of exchange within the narrow range fixed by the upper and the lower *specie point*. But the role that was assigned to the monetary policy under this system led to relatively very wide fluctuations in the internal price level. In other words, the Gold Standard system dictated that in the event of a conflict between the objectives of internal stability and external stability, the role of monetary policy was to sacrifice the former in favour of the latter objective.

However, the great depression demonstrated the futility of the role which the Gold Standard dictated to monetary policy. The relaxing of credit conditions and lowering of interest rates failed to revive the capitalist economies of the world. On the other hand, the strains of adjusting the internal prices in the interest of exchange stability further aggravated the situation of low level of output and employment. Due to various institutional developments like the trade unions as well as technological considerations there have developed a number of rigidities as regards price. Therefore, prices cannot be meant to serve the interest of stability of foreign exchange rates without serious effect on the level of output and employment. Moreover, even among the advanced countries the exchange rate is equally important for every one of them. In a country like the U.S.A. in whose economy foreign trade occupies an insignificant place compared to the domestic sector, stability of exchange rate is much less important compared to internal stability, while in countries like the U.K. and Japan where foreign trade makes a significant contribution to the national income, stability of exchange rate may

be relatively more important. It is obvious that even within this narrow framework the role of monetary policy cannot be uniform for all advanced countries. However, what is more relevant in the context of our present argument is that the experience of the Great Depression led to the belief that monetary policy has hardly an independent role to play during depression which can be corrected only by an appropriate fiscal policy. This view was formalised in the Keynesian economies in the form of the Liquidity Trap Hypothesis. It was believed that "money does not matter" and therefore monetary policy had no role to play in such economic situation. A less extreme and more reasonable conclusion was that monetary policy can at best play a supporting role of fiscal policy.

In the post world war situation which has been characterised by a continual process of inflation, the above said extreme view regarding the role of monetary policy no longer prevails. But still there are differences of opinion over the matter. The Radcliffe Committee (1959) in the U.K. as well as the Commission of Money and Credit (1961) in the U.S.A. still did not assign a very active role to the monetary policy. But the monetarists led by Milton Friedman have been putting a great stress on the monetary policy in the management of national economies. We shall try to summarize the academic opinion on the matter in the following paragraphs.

A detailed investigation into the working of the monetary system of the U.K. led the Radcliffe Committee to view that monetary policy in a developed country like U.K. might perform basically two roles: a long term or "background" role and short term or "emergency" role. The long-term role has to be appreciated in the light of the fact that steady-state growth requires a dynamic equilibrium between saving and investment. While investment may be insensitive to changes in the short-term rates of interest, it is not insensitive to the long term rates of interest. Therefore, the long term rates of interest are deemed to determine the balance between saving and investment. If this is accepted it follows that the long term rates of interest should not be allowed to fluctuate too much lest it should disturb violently the dynamic equilibrium between saving and investment. Therefore, it is argued that the monetary policy should be so devised as to ensure an approximate balance between saving and investment taking place in the economy.

The above conclusion should not be interpreted to mean that the monetary authority should peg the long-term rates of interest. Such a monetary policy will render all debt equally liquid which could increase the liquidity of the economy dangerously. The end of the monetary policy should be the stabilisation of the long-term rates of interest rather than to freeze them at any given level.

The experience of the Great Depression has pointed towards the

ineffectiveness of monetary policy in situations of severe depression. But it need to imply that monetary policy had no role in such a situation. As we observed earlier, the monetary policy can play a supporting role to the fiscal policy which has to play a more active role in such a situation. In fact, the Radcliffe Committee had come to the conclusion that in the short-term emergency situation of severe deflation, or severe inflation, there is a definite role that monetary policy can play.

The committee recommended a package of both monetary and fiscal measures to deal with such situations. The commission on Money and Credit in U.S.A. also arrived at a similar conclusion, though they appeared to give a little more importance to monetary policy than the Radcliffe Committee.

Friedman's position on the role of monetary policy proceeds his basic thesis that money stock determines the nominal variables and not the real variables. Hence, he has argued that there are certain objectives which monetary policy cannot achieve and therefore, it should not be employed to achieve these ends. Important among these objectives are the pegging of the real rate of interest and fixing the level of unemployment. The role that Friedman would like to assign to the monetary policy may be described as "neutral" role which should not try to distort the balance of real forces. The equilibrium rate of interest is determined by the balance between saving and investment which are the real forces. An attempt to influence the rate of interest through the monetary policy of increasing the stock of money in the economy may depress the market rate of interest in the short run, but the increased demand for goods resulting therefore is bound to raise not only the prices of goods but also the *nominal* rates of interest so that in the long run monetary policy will fail to influence the real rates of interest that is, the nominal rates corrected for the expected rate of price inflation. The argument with regard to the level of unemployment is similar. An increase in money supply, for example will raise prices, wage rates lagging behind temporarily. But soon the workers will bargain for higher nominal wages for they are interested in real wages rather than nominal wages. Therefore, while employment may increase temporarily, it will again decrease when nominal wages rise sufficiently to come in line with the rising prices and the real wages are restored to the natural level.

In view of the above argument, Friedman has been pleading the view that monetary policy cannot play the role of pegging the interest rates of fixing the level of unemployment. On the contrary he has been arguing that monetary policy should not be employed to smoothen out cyclical fluctuations. He is all out against what may be described as a "discretionary" monetary policy. Instead he has argued for a "formula" monetary policy. In brief, Friedman argued that the appropriate

target variable to be operated upon by monetary policy is the money stock and it should be manipulated in a manner so that it increases more or less at the same rate at which the real output of the economy is increasing on the average. Only thus can money be prevented from becoming a major source of economic disturbance and in the opinion of Friedman, the real function of monetary policy should be to prevent money from becoming a major source of economic disturbance. Moreover, the monetary policy should lend support to the strength and stability of financial system. This implies that in the event of a financial crisis, the money supply should not be allowed to contract sharply. The formula suggested above for the growth of money supply also implies that the role of monetary policy is to provide a stable economic environment in the form of keeping the price level more or less stable so that there are no distortions in the allocation of resources.

In brief, Friedman looks upon the role of monetary policy as one of controlling monetary aggregate with a view to ensure a stable economic background for allocation as well as growth in the form of stable price level. The monetary policy should avoid sharp changes in policy which causes uncertainty and instability. Its sole aim should be to control the money stock rather than the price level because while the price level is indeed influenced by the money stock, prices are not directly controllable.

Monetary policy has an international aspect too which is linked with the problem of maintaining the foreign exchange value of the national currency of a country. As already noted stability of foreign exchange rate should normally be not important for a country having a very extensive domestic sector and only an insignificant foreign sector in its economy. But for countries where foreign trade and payments are very important and/or where a currency is widely held internationally and where there are few barriers to short term international capital flows, stability of foreign exchange rate cannot be unimportant. Fluctuating exchange rate can wreak havoc in such economies by creating uncertainty and dynamic instability. Therefore in such economies monetary policy has to play the role of stabilising the foreign exchange value of the national currency. But this role often comes into conflict with the role of ensuring internal economic stability. For example, domestic interest rates cannot be insulated from the international rates. Any attempt to do that will be automatically negated by the capital flows "Nevertheless", as A. D. Bain has observed, "while international considerations limit the scope for domestic monetary policy they do not eliminate it entirely."

MONETARY POLICY IN LESS DEVELOPED COUNTRIES

The post war period has been characterised by the desire and efforts of the less developed countries of the world to bring about a rapid development of their economies through economic planning. Planned economic development of these countries raises a host of policy issues among which the issue of the role that monetary policy should play in such countries is one of the most important one.

Generally speaking there are no reasons to suppose that the role of monetary policy in less developed countries is entirely different from its role in the developed countries. The less developed countries need a stable economic environment for development no less than the developed countries need it for their steady growth. Therefore, in this respect, the role of monetary policy in the LDC's should be similar to that in advanced countries. In other words, the monetary policy in LDC's should also aim at stabilising the internal price level as well as the foreign exchange value of the national currency. It is because the aim of rapid economic development cannot be achieved when prices are rising or falling unpredictably and the exchange rates are also fluctuating. Such an unstable economic environment creates too much uncertainty which may dampen enterprise, discourage saving as well as inflow of foreign capital and also introduce distortions in the allocation of resources which reduces efficiency. All of these factors reduce productivity and consequently the rate of economic growth. Apart from it, in so far as rapid economic development in these countries is sought to be brought about through economic planning this is not possible in an environment of unstable prices and exchange rates which makes nonsense of all economic planning. A minimum degree of price stability is the *sine qua non* of economic planning.

The above does not imply that there is no difference between the role of monetary policy in the developed and less developed countries. In the first place, the monetary policy in the developed countries is concerned much more with *maintaining* conditions of near-full employment and "fine-tuning" the economy in order to prevent cyclical fluctuations that arise with attaining some rate of growth of economy. But, in the less developed countries where economic development is the most important objective of economic policy, monetary policy has to play a role which facilitates the attainment of this objective and gives top priority to this goal. The process of economic development is accompanied by the progressive monetisation of the subsistence sector, in consequence of which the demand for money naturally increases. Moreover, economic development also requires increased saving which is also facilitated by the use of money. In the absence of money, people put their savings in the form of real assets such as gold

and real estate which is not *conducive* to productive use of savings. But savings in the form of money not only bring in income to those who save but also acts as a conduct pipe bringing these savings to those who invest and make a productive use of such savings. This expansion of money serves as a productive factor in less developed economies. Hence, the monetary policy in LDC's should be concerned with the bringing of greater and greater part of the traditional subsistence sector of the economy within the ambit of money economy for which an expansionary policy has to be followed. An expansionary monetary policy is also necessary as a means of mobilising resources for rapid economic development. This, no doubt implies an inflationary policy which is expected to push up the rate of economic growth in at least two ways. First, a mild inflation which is almost unnoticed and therefore, unexpected; would provide more resources through "forced" savings. Secondly, it is likely to change the distribution in favour of those who save and invest and against those whose propensity to consume is too high. However, this argument is valid only when the expansionary monetary policy is such that it results only in a mild inflation which is not expected. It is not obvious, therefore, that stability of prices in the context of less developed economies does not have exactly the same connotation as it has in the context of the developed economies. The monetary policy in LDCs must take note of it. In a nutshell, we can say that monetary policy in the LDC's has to aim at a controlled expansion of money which admits of a mild but not a substantial rate of inflation.

The monetary policy of LDCs has an international aspect too. A mildly rising price level which was advocated in the preceding paragraph need not imply that the foreign exchange rate of the national currency will have to be lowered. Monetary policy should normally avoid devaluation, specially because the developing countries have to import highly valued capital goods from the developed countries. Devaluation is more likely to enhance the import bill than to increase export earning. Most of the exports of the LDCs consist of goods with low elasticity of demand and have unfavourable terms of trade. Therefore, devaluation cannot normally prove to be an effective means of correcting a deficit in the balance of payments of a LDC.

MONETARY POLICY IN INDIA

During the pre-independence period the monetary authority in India, that is, the Reserve Bank of India (RBI) did not have any active monetary policy to follow except for efforts to maintain the foreign exchange value of rupee. This is obvious from the fact that it did not change the bank rate, which was pegged at 3 percent till November, 1951. After independence, with the introduction of the

Five Year Plans, the need for appropriate adjustment in monetary and fiscal policies to suit the pace and pattern of planned development became imperative. The monetary policy since 1952 emphasized the twin aims of the economic policy of the government :

(i) Speed up economic development in country to raise national income and standard of living, and

(ii) To control and reduce inflationary pressure in the economy.

This policy of the Reserve Bank of India since the First Plan period was termed broadly as one of controlled expansion. Since 1973, due to inflationary pressures, the trust of RBI's monetary policy has been exclusively on control of inflation.

Let us study the monetary policy since 1951:

The role of monetary policy during the First Five Year Plan (1951-56) was visualised, as that of allocation of resources in conformity with the plan objectives. The need for extending the network of credit institutions was also recognized. Deficit financing (i.e. central bank credit to govt.) was assigned a place in the financing of the plan though its quantum was to be limited to the extent it was non-inflationary. A moderately restrictive monetary policy was followed.

In the Second Plan (1956-61) the emphasis on capital goods industries was indicative of the inflationary pressures that might be generated. The Selective Credit Control Scheme was also introduced in May 1956 covering advances against selected essential agricultural commodities with a view to discourage speculative holding of stocks in the context of shortages in foodgrain supplies. The RBI was given powers in 1956 to vary the reserve ratio between 5 per cent and 20 per cent of the banks demand liabilities and between 2 and 8 per cent of their time liabilities in India.

During the Third Plan (1961-66) money supply (M_3) grew at an annual average rate of 9.1 percent. Hostilities on the border in 1962 led to heavy expenditures on defence. The severe drought of 1965-66 led to a fall in national income and an inflationary spurt in prices. The scope for drawing down foreign exchange assets was negligible. In response to these factors causing severe stresses and strains on the economy, the RBI followed a credit policy of restraint. In 1964, the Reserve Bank introduced a system of differential interest rates for refinance based on the net liquidity positions, (defined as gross liquidity less borrowings from RBI), maintained by the borrowing banks. The RBI introduced the Credit Authorisation Scheme under which prior authorisation of the Reserve Bank had to be obtained by banks for sanctioning fresh working capital credit limits if such sanction resulted in borrowers enjoying total credit limits of Rs. 10 million or more from the banking system.

A scheme of social control over banks was introduced by the govt. and a National Credit Council was set up so that bank credit could be more effectively used as instrument of development.

In July 1969, 14 major Indian commercial banks were nationalised. With this, nearly 85 per cent of bank deposits came under the direct control of the govt.

A policy of controlled expansion was followed from 1951-72. RBI resorted to expansion of money and credit, and attempted to check rise in prices by use of selective controls.

Since 1972, an anti-inflationary policy has been adopted. The inflationary situation was due to the increase in money supply with the public and banking system ; it was fuelled by fluctuating agricultural production, faulty govenment policies and global inflationary situation (due to hike in oil prices). Hence a tight monetary policy was adopted, but RBI failed to restrict the expansion of bank credit/money supply to the targeted levels.

Beginning 1992-93, the Govt. of India adopted a policy of lowering fiscal deficit. The system of adhoc treasury bills was discontinued in 1997. More reliance was placed on open market operations. In fact, the entire concern of monetary policy in 1990s was to ensure adequate expansion in credit to assist industrial growth.

The monetary and credit policy for the first half of 1998-99 indicated further strengthening of existing capital adequacy, income recognition and provisioning norms in the light of the recommendations of Narasimha Committee on Banking Sector Reforms (December, 1997). The stance of monetary policy since 2000-01 laid emphasis on provision of sufficient credit for growth without causing inflationary pressure in the economy. There was no change in the stance of monetary policy in 2003-04. The focus was on providing adequate liquidity to meet credit needs and supporting investment demand in the economy while continuing a vigil on movements in price level.

In its Annual Policy statement for 2005-06, the RBI delineated the objectives of its monetary and credit policy stance as (i) provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy, while placing equal emphasis on price stability; (ii) to achieve the above, an interest rate environment conducive to macroeconomic and price stability while maintaining the momentum of growth was to be pursued; (iii) the above measures were to be considered in a calibrated manner, with a view to stabilising inflationary expectations.

For the policy of 2006-07 the overall stance of the monetary policy was to (i) to reinforce the emphasis on price stability and well anchored inflation expectations while ensuring an interest rate environment that supports export and investment demand; (ii) to reemphasise credit quality and orderly conditions in the financial markets.Beginning mid-september 2008, an accomodative monetary policy was pursued, which mitigated the adverse impact of the global financial crisis on the economy. However, in view of the rising food inflation, the RBI started exiting from the expansionary monetary policy in October 2009. In 2010, the monetary policy actions were intended to moderate inflation as well as maintain financial conditions conducive to sustaining growth. The monetary policy stance during 2011-12 moved from tightening driven by inflation concerns to gradual pause recognizing the risks to growth as inflation moderated marginally. The monetary policy in 2012 intended to :

(i) maintain an interest rate environment to contain inflation and anchor inflation expectations ;

(ii) manage liquidity to ensure that it remains in moderate deficit ;

(iii) respond to increasing downside risks to growth.

The Reverse Bank of India Act 1934 was amended by the Finance Act, 2016, to provide for a statutory and institutionalised framework for a Monetary Policy Committee (MPC), for maintaining price stability along with the objective of growth. The MPC is entrusted with the task of fixing the benchmark policy rate (repo rate) required to contain inflation within the specified target level. Out of the six members of MPC, three will be from the RBI and three will be appointed by the Central Government. With the formation of MPC, the Technical Advisory Committee (TAC) on monetary policy ceased to exist.

4. An Assessment of India's Monetary Policy

In retrospect, it appears that the monetary policy in India has not been adequately successful in achieving the objective of accelerating economic development with stability. It has a number of lacunae, which combined with the lacunae in the monetary system of an under developed economy like India, were responsible for its failure.

There was hardly any predetermined plan chalked out by the RBI for use of the various types of controls. Consequently the monetary policy of the RBI, though it aimed at 'controlled expansion,' was, in retrospect, a policy of cautious improvisation.

The RBI was reluctant to pursue a sufficiently restrictive policy because it feared that such a policy might hinder the progress of economic plans in the country. The goal of stability was sacrificed at the alter of expected rapid economic development which not only made inflation endemic, but also because of this

endemic inflation, slowed down the realised rate of economic development.

The preponderance of currency in the total money supply, which was as high as 62% in 1951 and which has now reduced to about 45% also did not allow the monetary policy to become effective. Lack of integration in the Indian market and very large non-monetised sector also accounted for the ineffectiveness of monetary policy.

A further complication was caused by existence of black money leading to the establishment of a sort of parallel economy which is beyond the reach of monetary and even other controls.

As the Radcliffe Committee in U. K. pointed out, it is not enough to control the money supply in order to control the aggregate expenditure and price level. It is the whole liquidity of the economy that must be controlled and for that non bank financial intermediaries (NBFI's) must also be brought under the control of the monetary authority. Since the RBI can exercise control limited over the NBFI's as well as the indigenous bankers, effectiveness of its monetary policy cannot but remain limited.

It has also been pointed out that policy makers must target the rate of growth of narrow money supply (M_1) rather than broad money supply (M_3). This is because in the Indian context time deposits with banks are abodes of savings rather than abodes of purchasing power. M_1, on the other hand, is found to have a predictable relation with prices and national income. Thus control of M_1 is important in influencing movements in economic activity.

Also, the absolute constitutional authority for implementation of monetary policy, leaves no space for the state governments to participate in the decision making process in this area. A uniform monetary policy for a diverse economic structure not only adversely affects economic outcomes, but also remains incapable of adapting to changing times.

Moreover, it is now generally acknowledged that monetary policy operating in isolation from the fiscal policy can never be fully effective. The Indian case bears a testimony to this proposition. RBI has failed to keep the expansion of money supply within proper limits primarily because of the fiscal policy of the Indian government which has been depending upon increasing the heavy doses of deficit financing thus greatly increasing the general liquidity in the economy.

In sum, we may say that the monetary policy of RBI has been one of cautious approach to the monetary discipline in which the central theme has been credit regulation and rationing without jeopardy to the flow of funds necessary for the development of the economy. But, at times, some exogenous factors and an unhelpful fiscal policy tended to destroy the effectiveness of this policy.

Suggested Readings

1. Suraj B. Gupta : Monetary Economics, Theory, Institutions and Policy
2. Datt and Mahajan : Datt and Sundharam Indian Economy

Questions for Practice

1. Critically examine the monetary policy of India since 1951.
2. Discuss role of monetary policy in developing countries.

LESSON NO. 1.5 **AUTHOR : DR. ANITA GILL**

CREDIT AND FINANCIAL SYSTEM

INTRODUCTION

Before we begin a discussion about the elements, structure and role of financial system, it is better to have an understanding of money, credit and its kinds since a financial system is concerned about these. We have already studied about money in the first lesson of the previous unit, so this concept will not be discussed here. But we will study in brief about credit and its kinds, and then go on to the structure and role of financial system.

CREDIT

Credit can be defined in various ways. In a broad sense, credit is the finance which is made available by one party to another party. Narrowly defined, credit refers only to debt finance. It is in this narrow sense that credit is generally used. It is thus, the opposite of debt, where debt refers to an obligation to make future payments. Credit then becomes a claim to receive these payments.

Credit and debt are created in the same act of borrowing and lending.
Just as in an exchange transaction there is a purchase for every sale, similarly in a credit transaction, there is an amount borrowed for every amount loaned, and the amount loaned is equal to the amount borrowed. Credit and debt are thus, two sides of the same picture.

It must be remembered that while money is the most liquid asset in which people choose to hold part of their wealth, credit consists of purchasing power lent or made available to borrowers. There can be such societies in which no money exists, but where credit can exist.

Bank credit is one form of credit. But it is not the same thing as money. Money is an asset of the holding public, and a liability of the banking system and the government. Again, it is not all the liabilities of the banking system that are money, but only those that serve as a medium of exchange, namely currency and demand deposits. On the other hand, bank credit is a liability of the borrowing public to banks and an asset of banks. Secondly, money serves as a commonly accepted medium of exchange and the unit of account. But bank credit itself does not serve as bank money. Only the demand deposits of a bank of which cheques can be drawn for settlement of payments, serves as bank money.

Credit and money are, therefore, not the same thing. And bank credit is only one form of credit. There are several other kinds of credit :

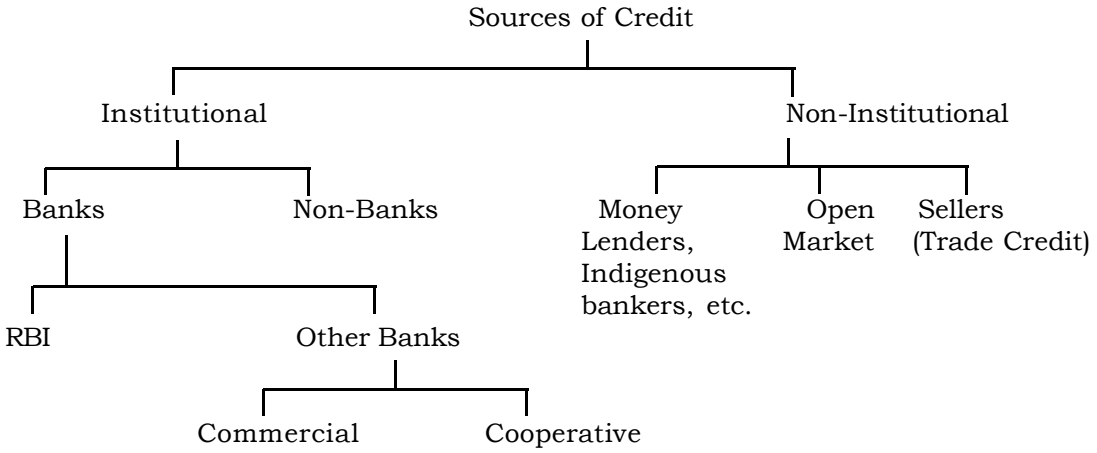
Kinds of Credit

It is important to understand that credit cannot be classified in a unique way. It can be classified in several ways, and each way will depict one particular aspect or

dimension of credit. According to Suraj B. Gupta "Credit can be classified from five different angles: (A) Source; (B) End-Use; (C) Users; (D) Term; (E) Cost."
We will deal with these classifications one by one.

(A) According to Source :

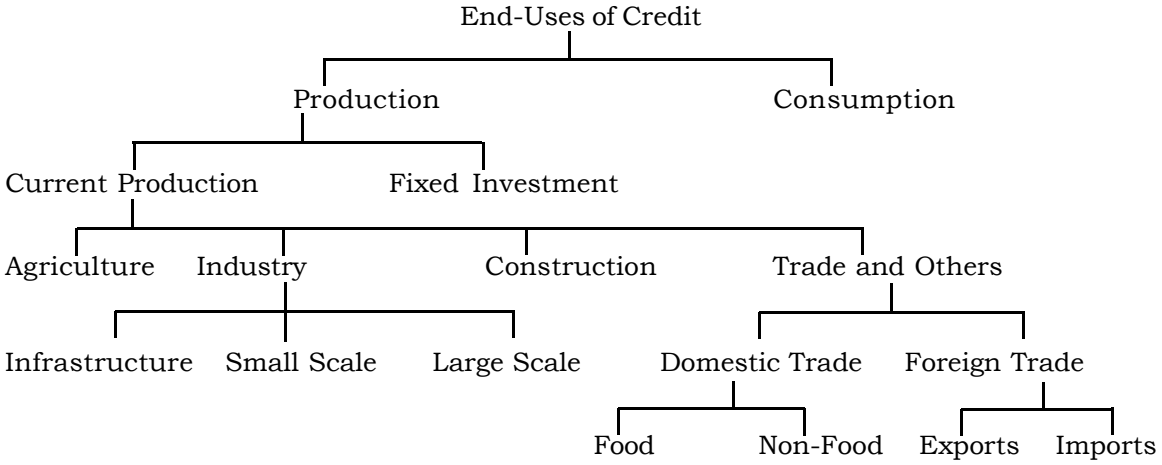
Credit is provided by a wide variety of sources. These sources can broadly be classified as institutional sources and non-institutional sources. In the former we can include the banks and non-bank institutions. The non-institutional sources consist of private lenders, indigenous bankers etc.



(Source: Suraj B. Gupta: Monetary Economics, Institutions, Theory and Policy)

(B) According to End-Use :

Since credit is a scarce resource, its proper allocation and end-use is of great importance. Credit is used in all economic activities - production as well as consumption. The end-uses can broadly be classified as under:



(Source: Suraj B. Gupta : Monetary Economics - Theory, Institutions and Policy)

It is also possible to cross-classify the above sectors of economic activity. One cross-classification can be the allocation of credit between the priority and non-priority sectors. Another one can be between rural and urban credit. For comprehensive credit planning, the end-use classification of credit is particularly important.

(C) According to Users

This type of classification of credit is not common, but is of much social importance. For example, the social objective of nationalisation of major commercial banks has been the reallocation of bank credit in favour of weaker sections of the community. This kind of social concern relates to the users of bank credit and not the nature of its use.

(D) According to Term

The time period for which credit is given is also an important dimension of credit. Since credit is required for various uses and in different quantities, the period after which it can be paid back also varies. For example, credit taken to buy raw material can be repaid after a short period, while credit taken to buy machinery or land, can be repaid only after a considerable time gap.

From the lender's side also, the term of credit is important. The length of time for which advances are made by the financial institutions depends on the nature of their liabilities. For example, if a commercial bank raises funds by selling deposits of short-term variety, it will prefer to make short-term advances. Similarly, since life insurance companies get long-term funds by selling long period insurance policies, they can afford to lend for long periods. However, ways and means are also devised whereby short-term funds can be transformed into long-term funds and vice-versa.

Term-wise credit is generally divided into three categories-short term, medium-term, and long-term credit. Short term credit is normally up to a year, medium term credit varies from one year to ten years; and long-term credit is usually for more than ten years. However, the time period may vary depending on the sector under consideration (agriculture, industry, etc.).

Also, short-term credit and long-term credit are not water-tight compartments. These are liquid funds that can be used in any manner. Short term funds may be used for long-term investments if there is delay in the receipt of long-term funds.

(E) According to Cost

The cost of credit varies over a wide range for different classes of borrowers and for credit from different sources. Classification of credit by cost does not follow any hard and fast rule. Generally speaking, from the viewpoint of cost, credit is divided into (a) cheap, (b) dear, and (e) usurious. But these are relative terms. Further complications are provided by risk of default, and the expected rate of inflation. Provisions for these two factors may vary greatly over time and circumstances governing borrowing and lending. An element of usury may also be present depending on the lender and the borrower.

Thus, before credit can be classified as cheap, or dear, or usurious, a number of factors have to be taken into account,

II

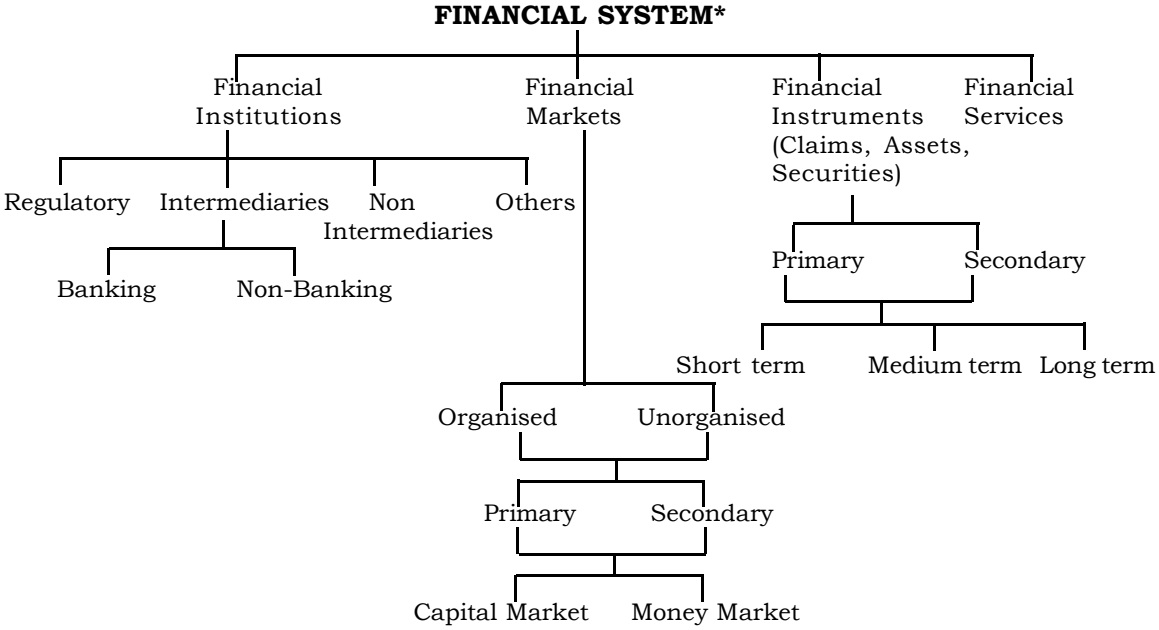
FINANCIAL SYSTEM

Before we begin to study about the financial system it is important to understand what is meant by finance. Broadly speaking, finance is a means to direct the economic and business activities by enterprises to attain their objectives.

The financial system of any country consists of specialized and non-specialized financial institutions, of organized and unorganized financial markets, of financial instruments and services which facilitate transfer of funds. The procedures and practices adopted and financial interrelationships are also part of the system. However, the parts of the financial system cannot be considered as mutually exclusive. In fact, the institutions, agents, practices, markets, transactions, claims and liabilities in the economy are all closely connected or intermixed.

A financial system should be carefully distinguished from a payments system. The payments system is concerned with payments in cash. But the financial system is a much broader term in the sense that it covers both cash and credit transactions. It is through this system that the financial surpluses in the economy are mobilised from surplus units and transferred to deficit spenders.

The typical structure of financial system in an economy can be understood with the help of the following figure :



*(Source: L.M. Bhole : Financial Institutions and Markets: Structure, Growth and Innovations)

Financial Institutions are business organisations which act as mobilizers and depositories of savings and as purveyors of credit or finance. The activities of different financial institutions may overlap, or these may be specialized, and their classification is normally done on the basis of the degree of their specialization with relation to savers and borrowers with whom they customarily deal with. In this spirit, one classification of financial institutions is into banking and nonbanking ones. The important difference between these two types of financial institutions is, that while banks can advance credit by creating claims against themselves, the non-banking institutions can lend only out of resources at their disposal. The distinction between these two types has perhaps best been highlighted by Sayers, who refers to banks as 'creators of credit', and to non-bank institutions as 'purveyors of credit.' In India, the banking system consists of the commercial banks, the cooperative banks, and the Reserve Bank of India. The non-banking financial institutions are the Life Insurance Corporation (LIC), Unit Trust of India (UTI), Industrial Development Bank of India (IDBI)* etc.

Another way of classifying financial institutions is to term these as intermediary and non-intermediary institutions. Intermediary institutions intermediate between savers and investors, i.e., they lend money as well as mobilize savings. Their liabilities are towards the ultimate savers, while their assets are from the investors or borrowers. On the other hand, non-intermediary institutions lend money, but do not obtain their resources directly from the savers. While all banking institutions are intermediaries, many non-banking institutions also act as intermediaries (and hence are called non-banking financial intermediaries or NBFIs). UTI, LIC, GIC are some NBFIs in India. Non-intermediary institutions are those that have come into existence mainly because of governmental efforts to provide assistance for specific purposes. Examples of such institutions are IDBI, NABARD, IFCI etc. These are also called Non-Banking Statutory Financial Organisations (NBSFO) because these have been set up by the government.**

The classification of financial institutions as intermediary and non-intermediary is no longer watertight, as most financial institutions which were earlier classified as non-intermediary have started mobilizing savings, and are thus taking on the role of intermediaries between savers and borrowers.

The next part of financial system consists of **financial markets**. Financial markets facilitate the buying and selling of financial claims and services. The participants on the demand and supply side of these markets are financial institutions, agents, brokers, dealers, borrowers, lenders, savers and others who are interlinked by the law, contracts and communication networks.

---

*IDBI has now been merged with IDBI bank w.e.f. October 2004.

** However, this classification no longer holds good, as these institutions can also now raise funds from the market.

There are several ways of classifying the financial markets. These can be classified as organised and unorganised. The unorganised market is largely made up of indigenous bankers and money-lenders. The market is unorganized because its activities are not co-ordinated by the RBI. The organised market comprises the RBI and banks.

Financial markets are also classified as primary and secondary markets. The primary market deals in new financial claims of new securities and is, thus, also called new issue markets. The secondary market deals in securities already issued or existing.

However, the most common way of classifying financial markets is on the basis of term of credit. While the money market deals in the short-term claims, the capital market does so in the long-term. But it must be remembered that it is not always' possible to include a given participant only in either of the two markets. For example, commercial banks belong to both markets. And while treasury bills market, call money market, and commercial bills markets are part of money market, stock market and govt. bonds market are examples of capital markets.

Since money and capital markets will be discussed in detail in the next two lessons, we move on to the next important part of the financial system, viz.

Financial Instruments: These are varied in character, depending upon the motive of lending and borrowing. In fact, the stage of development of a financial system can be judged from the diversity of financial instruments that exist in the system. Financial instruments differ from each other in respect of their investment characteristics. Some of these characteristics are-liquidity, marketability, transaction costs, maturity period, risk of default etc.

Financial Services: Financial intermediaries provide key financial services such as merchant banking, hire purchase, leasing, credit rating and so on. Financial services bridge the gap between lack of knowledge of investors and the ever increasing sophistication of financial instruments and markets.

Although the list of services provided by the financial system is endless, yet we can identify three key services which are provided by financial system, and which are embedded in each individual service (of merchant banking, leasing, factoring, hire-purchase etc.) These services are

(i) Risk sharing : Risk is the chance that the value of financial assets will change relative to what is expected. By allowing savers to hold different types of assets, financial system provides risk sharing. Financial markets can create instruments to transfer risk from savers or lenders who do not like uncertainty to savers or investors who are willing to bear risk. The ability of the financial system to provide risk sharing makes savers more willing to buy borrowers' IOUs. This willingness, in turn, increases borrowers' ability to raise funds in the financial system.

(ii) Liquidity : Liquidity is the ease with which an asset can be exchanged for

money to purchase other assets or exchanged for goods and services. Savers view this liquidity of financial assets as a benefit. Financial assets created by the financial system, such as stocks, bonds or checking accounts are more liquid than cars, machinery, or real estate. Financial markets provide trading systems for making financial assets more liquid. In addition to creating financial assets, financial system also provides for ways and means of increasing the liquidity of financial assets. In fact, the extent to which a financial system can transform illiquid assets into liquid claims is a measure of the efficiency of the financial system. This is because savers are willing to accept a lower return on assts with greater liquidity, reducing the costs of borrowing obligation.

(iii) Information : Financial system provides the service of collection and communication of information, or facts about borrowers and expectations about returns on financial assets. It gathers information about prospective borrowers and what they will do with borrowed funds. Collection of such information by individual savers is costly and time consuming. Financial system communicates this information. Savers and borrowers receive the benefits of information from the financial system by looking at asset returns. Incorporation of available information in asset returns is a distinguishing feature of a well functioning financial system. A problem that exists in most transactions is asymmetric information. This means that borrowers possess information about their opportunities/activities that they do not disclose to lenders/creditors and can take advantage of this information. Parts of financial system specialize in information gathering and monitoring, and specialized arrangements exist for solving problems of asymmetric information.

Having studied briefly the structure of financial system, let us see what role can the financial system play in the economic development of a nation.

FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT:

Money and finance cannot bring about economic development by themselves, but they can play a significant role in bringing about economic development. The financial system helps production, capital accumulation and growth by encouraging, mobilising and allocating them among alternative uses/users.

In every economy, in a given period of time, there are some people whose current expenditure is less than current income, while for some people, current expenditure is more than current income. These two categories of people are called the 'ultimate savers' and 'ultimate investors' respectively. The function of a financial system is to establish a bridge between the savers and investors and thereby help mobilisation of savings and fructification of investment ideas into realities.

The financial system promotes savings by providing a wide choice of financial assets as stores of values, with attractive combinations of income, safety and yield. Thus, it is said that saving-income ratio is positively elastic with respect to both financial

assets and financial institutions. Again, all the individual savings need to be collected or mobilised before they can be spent by the deficit spenders (i.e. investors). Here too, a financial system is a highly efficient mechanism for mobilising savings. Mobilisation of savings takes place when savers move into financial assets. With institutionalisation of savings, it becomes possible for the deficit spending units to undertake more investment expenditures because the financial system enables them to command more capital.

Further, a financial system not only encourages investment, it also efficiently allocates resources in different investment channels. It helps to sort out and rank investment projects by sponsoring and encouraging business units or borrowers through project appraisal and monitoring. The moneylenders and indigenous bankers too provide credit, but there are several deficiencies in their allocation of finance. But the allocative role of financial institutions is very important. For example, only corporations can go to the stock market for raising funds through public issue of equity shares and bonds. Non-corporate borrowers cannot issue marketable liabilities, and have to depend on bank finance or private finance. Since there is credit rationing, the financial institutions (subject to the policy of the govt. and the RBI) determine the allocation of institutional finance among various competing borrowers. The financial institutions can make firms grow faster by providing them easy credit. They can also hinder the development of firms by denying them adequate credit. Thus, the allocative role of financial system cannot be ignored while discussing its function in economic development.

Apart from merely encouraging investments that are based on prior saving, the financial system plays a positive role by providing finance or credit through creation of credit* in anticipation of savings. This makes investment independent of saving in a given period of time. However, investment out of created credit should not be faulty and should promptly result in income generation.

A financial system also enhances, the efficiency of the function of medium of exchange and thereby helps in economic development. It facilitates the normal production process and exchange of goods, and enlarges, markets over space and time.

To conclude, the relationship between economic development and financial development is mutually reinforcing. The financial system accelerates development, and in turn, grows with economic development. The relationship between the two is, thus, symbiotic.

However, it is better to take a cautionary view of the role of financial markets in development. First, it has been argued that the financial sector can perform the developmental role if it functions efficiently, but it is not so in practice. According to Tobin, although the financial system might serve us well, but its functioning should

---

* L.No. 8 in Semester-III has already dealt with creation of credit function of commercial banks.

never be viewed in a complacent manner. Financial activities generate high private reward disproportionate to their social productivity. Secondly, the role of capital formation and finance even in development has been unduly stressed. Better composition of capital and appropriate technology can reduce the need for a lot of finance. Empirically it has been found that the rate of capital formation increased without raising the growth rate, and capital accumulation could account for at most one-fourth of the rate of economic growth in the 19th and 20th centuries. Increase in capital without suitable social, economic, political conditions cannot cause growth. Thus, finance is not the be all and end all of development.

Suggested Readings

1. Suraj B. Gupta : Monetary Economics; Theory Institutions and Policy.
2. L.M. Bole : Financial Institutions and Markets : Structure, growth and innovations.
3. S. Gurusamy : Financial Markets and Institutions.

Questions for Practice.

Long Answer Type :

1. Define Credit. Discuss kinds of credit.
2. What is meant by Financial System? Give in detail its structure.
3. Discuss the relationship between financial system and economic development.

Short Answer Type Questions

1. What are the possible end uses of credit?
2. State the difference between money and credit.
3. Write a brief note on cost of credit.
4. Give three key services provided by a financial system.

LESSON NO. 1.6 **AUTHOR : RAKESH KUMAR**

MONEY MARKET

INTRODUCTION

Financial markets may be broadly classified as negotiable loan markets and open markets. The negotiable loan market is a market in which lenders and borrowers personally negotiate the terms of the loan agreement. A business person borrowing from a bank and an individual borrowing from a small loan company are examples of negotiated loans. In contrast, the open market is an impersonal market in which standardized securities are traded in large volumes. Buyers and sellers may never meet. Stock market is an example of an open market. The open market provides the binding that ties the country's financial institutions together into an integrated whole. It is only with the open market that we will be concerned with in this and the next lesson.

This lesson is divided into three sections. Basic knowledge about money market and characteristics of a developed money market are discussed in the first section. Section II deals with the various components of money market. Money market in India and its development is a part of section III.

I

Money market is a market for short term (less than one year) loans. Infact, its very name suggests that it is money which is being bought and sold. It is used by business firms for purchase and shipment of inventories, by finance companies to finance consumer credit, by banks to finance temporary reserve shortage, and by government to bridge the gap between tax receipts and expenditure. The money market is not a place but an activity.

A supplier of funds to the money market can be virtually anyone with a temporary excess of funds, for example, a corporation may be accumulating funds for a quarterly income tax payment, and rather than holding the funds in demand deposits (non-interest bearing), the corporation may decide to lend them out for a short term. A commercial bank may know from experience that it will have large seasonal deposit withdrawals shortly but in the meantime it may invest the money in earning assets.

The best way to a clear impression of the money market is to understand the mechanism of the various debt instruments traded in it. The description of the money market involves both the instruments and institutions. All the money markets, though constituted differently, have institutions which have somewhat similar character.

CHARACTERISTICS OF A DEVELOPED MONEY MARKET

A developed money market is one which is comparatively efficient in the sense that it is responsive to changes in demand for and supply of funds in any of its segments. The effects initiated in any part of it, quickly spreads to others without significant time

lag. In order to satisfy these criteria it should have the following characteristics:

(a) Presence of Central Bank

Central bank has a greater capacity of judging the needs of the market as regards its financial requirements and can devise its monetary policy to suit the objectives. It can vary the supply of cash and easily meet the seasonal variations in demand for liquidity by rediscovering the commercial paper. It can supplement this task by varying the minimum reserves to be maintained by the banks, the bank rate and use of selective credit controls etc.

(b) A Developed Commercial Banking System

For a developed money market not only the banks should be well developed and organised, but the public should also have a widespread banking habit. Widespread banking habits of the public enable banks to operate on low fractional reserves.

(c) Variety and Quantity of Financial Assets

It is essential that there should be an adequate supply of a variety of short maturity financial assets. In developed money markets there is an abundance of various financial assets like commercial bills, bills of exchange, treasury bills and so on.

(d) Sub-markets

A developed money market will have developed and sensitive sub-markets. Absence of such markets or lack of their responsiveness to small changes in interest and discount rates, does not make it a developed money market.

(e) Existence of Specialized Institutions

The existence of institutions specializing in particular types of assets help in making the money market competitive and efficient. Acceptance houses and discount houses are important examples.

(f) Contributory Legal and Economic Factors

Appropriate legal provisions go a long way in the development of money market. The transaction costs of commercial bills should be quite nominal. In India, one of the reasons for non-development of bill market happens to be the high stamp duty payable on them. Similarly, the dealers in bills should have a legal protection against default of payment and remedial provisions should not be very time-consuming.

Money market would remain undeveloped if one or more of above conditions are not satisfied.

INSTRUMENTS OF MONEY MARKET

Money market works through market instruments. Let us now discuss various instruments of money market one by one.

Call Money

Call money loans are extremely short term loans which are repayable on demand within a day. They are made by commercial banks and other financial institutions who

can afford to spare funds in large amounts, though for short periods. The maturity period is between 1 to 15 days. The demand for such loans comes from those financial institutions which specialize in discounting or rediscounting bills.

The call money market operates through brokers who keep in constant touch with banks and bring the borrowing and lending banks together. The main function .of the market is to redistribute the pool of day to day surplus funds of banks among other banks in temporary deficit of cash. The call money market is a highly competitive and sensitive market. It registers very quickly-the pressure of demand and supply for funds operating in the money market. The funds are borrowed or lent without any collateral security. The rate of interest paid on call loans is called call rate.

Treasury Bills

The market which deals in treasury bills is termed as treasury bill market. These bills are short-term liability of the government. Treasury Bill is a particular kind of finance bill (which does not arise from any genuine transaction in goods) i.e. a promissory note put out by the government of a country. They are issued to meet temporary needs for funds of the government arising from temporary excess of expenditure over receipts. Treasury bills are of two kinds: adhoc and regular. Adhoc means for the particular end or case at hand. Adhoc treasury bills are issued for providing investment outlets to state governments, semi-government departments etc.

Regular Treasury Bills (or ordinary TBs) are sold to general public and banks. They are freely marketable. In India, their buyers are almost entirely commercial banks.

Treasury bills are bought and sold on discount basis. The amount of interest due on it is paid in the form of discount in the price charged for the bill. This price is, thus, lower than its face value by the amount of interest due on the bill. For the government, treasury bills are an important source of raising funds. In India, treasury bill rates are very low, which in turn, keep the interest cost of treasury bill debt to the government very low.

Commercial Bills

The market dealing in commercial bills is known as commercial bill market. These bills are issued by firms engaged in business. Generally, they are of three months maturity. They are like post-dated cheques drawn by sellers of goods on the buyers of goods for value received.

An example of typical bill of exchange is given below :

Patiala, Oct. 15, 2010

Mr. Sharma,

Three months after date please pay to the undersigned or order of the sum of Rupees thirty thousand for value received.

Mr. Khurana

In this example, Mr. Khurana is the drawer of the bill and Mr. Sharma is the drawee. The former has sold the latter goods worth Rs. 30,000/- on three months credit. The seller may need cash now, so he draws a bill and sends it to the buyer for acceptance. The latter, in acknowledgement of his responsibility to make payment on the due date, writes 'accepted' on the bill, or arranges to get the bill accepted on his behalf by his bank. Once the bill has been so accepted, it becomes a marketable instrument. On receipt, the drawer can now sell it in the market for cash. The bank, again, normally comes into picture. The drawer goes to his bank and gets the bill discounted. This simply means that he sells it for cash to the bank which pays him the face value of the bill less collection charges and interest on the amount for remaining life of the bill. The rate of interest charged is known as the discount rate on bills.

A Commercial Bill is, thus, a written instrument containing an unconditional order, signed by the maker directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument. Being a negotiable instrument, it can change ownership.

While in developed economies, commercial bills are a major portion of the money market, in underdeveloped countries this is not the case, for various reasons. These economies have a practice of trading through payment rather than· buying on credit. Also, for a genuine bill market to develop it is essential that the bills should be drawn in a largely accepted conventional form and the banks and other agencies of repute should be ready to stand guarantee for the credit worthiness of the drawee of the bills.

Commercial Paper (CP)

Commercial paper consists, very simply, of the unsecured promissory notes of large corporations. The corporations are sufficiently well-known so that their credit worthiness is not in doubt. Their promise to pay can consequently be bought and sold in an organised market. The commercial paper generally carries a maturity of 4 to 6 months and is used by the issuers as a supplement to borrowing from commercial banks. These are also known as Industrial Paper, Finance Paper, Corporate Paper, etc. CPs are sold either directly by the issuers to investors or through agents like merchant banks and security houses. In India, CPs are privately placed with investors through banks or financial institutions. These are used to raise short term finance to meet working capital needs. These are issued in domestic as well as international financial markets. These are rarely issued to finance fixed assets or permanent capital.

Certificates of Deposits (CDs)

A CD is a document of title to a time deposit. A certificate of deposit is a certificate given by a commercial bank that certifies that a deposit has, infact, been made. The certificate stipulates that the deposit cannot be withdrawn before a certain date and that, upon that date, the bank will repay the deposit plus interest. This period is generally

three months. Certificates of deposit are of two kinds : non-negotiable and negotiable. A non-negotiable certificate of deposit must be redeemed by the original depositors. A negotiable certificate of deposit, however, may be resold by the depositor in the money market and may change hands several times before it matures. Whosoever owns the negotiable certificate of deposit on its maturity date, of course, claims the deposit and interest from the bank.

The above mentioned instruments are the basic constituents of the money market. The market operates through these instruments. Development of any economy can also be judged from the development of its money market.

III

MONEY MARKET IN INDIA

Until 1935, the country had no central bank. The government had the right to issue currency. The banking structure was very fragile and bank failure was very common. The money market that existed in pre-independence period was far more undeveloped, than what it is today. Now the Indian money market is a leading money market in third world countries.

Indian money market is broadly divided into two parts, viz. the unorganised and the organised. The unorganised sector of money market comprises the indigenous bankers and money-lenders. They charge comparatively high rates of interest. Unlike the modern banking system there are little business relations among them. The organised sector is fairly integrated. Both private and public sectors constitute the organised sector. The RBI is the central bank, and it is the apex organisation in the Indian money market.

No doubt, the organised sector of the Indian money market is fairly developed and organised, yet it is not comparable to the New York or London money market.

Broadly, the **principal constituents (sub-markets) of Indian money market are :** (i) Call money market, (ii) Treasury Bill market, (iii) Commercial Bill market, (iv) Certificate of Deposit market and (v) Commercial Paper market.

(i) The Call Money Market

Scheduled commercial banks, cooperative banks and Discount and Finance House of India operate in it as lenders and borrowers. As a special case, institutions like Unit Trust of India, Life Insurance Corporation of India, General Insurance of India, Industrial Development Bank of India and the NABARD are allowed to operate in the call money market as lenders. Among the banks, the State Bank of India, on account of a strong liquid position is invariably on the lender side of the market. The call money market, on account of its highly sensitive nature" is considered to be the most appropriate indicator of the liquidity position of the money market. The RBI, therefore, takes note of it in adjusting day to day monetary policy.

The call money market remains largely confined to big industrial and commercial

centres like Mumbai, Kolkata, Chennai, Ahmedabad, Bangalore etc.

(ii) The Treasury Bill Market

The treasury bills are instruments for short term (91 days, 182 days, 364 days) borrowing by the central government. In these days, in India, treasury bills have become a permanent source of funds for the central government, as every year more new bills are issued than those that are retired. Further, every year a part of treasury bills held by RBI is converted into long term bonds. The treasury bill market in India is highly underdeveloped. Except RBI there are no major holders of these bills. Infact, even the RBI is a passive or captive holder of these bills which implies that it is under an obligation to purchase all the treasury bills presented to it by banks and others for this purpose. This has resulted in monetization of public debt and has become a major source of inflationary expansion of money supply. State governments do not issue any treasury bills. Interest on these bills is market governed. Treasury bills are available for a minimum amount of Rs. 25000 and in multiples of Rs. 25000.

(iii) The Commercial Bill Market

In India, this market is highly undeveloped. Generally, cash credit system of bank lending is popular. Among other factors which have prevented growth of genuine bill market are lack of uniformity in drawing bills, high stamp duty on the bills, and the practice of selling on credit without specified time limit. RBI had made efforts to develop a bill market in this country and popularise the use of bills. Its two specific bill market schemes, however, had limited success. The old bill market scheme introduced in January 1952 was not correctly designed to develop a bill market. It merely provided for further accommodation of banks in addition to facilities they had already enjoyed. In order to encourage use of bills the RBI offered loan at a concessional rate of interest and met half the cost of stamp duty incurred by banks on converting demand bills into usance bills. This scheme, however, failed to make any impact.

Not satisfied with the old scheme, the RBI introduced a new bill market scheme in November 1970. The noteworthy features of this new scheme were:

(i) The bills covered under the scheme are genuine trade bills and (ii) the scheme provides for their rediscounting. This scheme really aimed at developing a bill market in the country but has not been very successful.

(iv) The Certificate of Deposit Market

The certificate of deposit instrument was introduced in Indian money market in 1989, with the objective of widening the range of money market instruments and to provide investors greater flexibility in deployment of their short terms surplus funds. The CDs can be issued the scheduled commercial, banks excluding Regional Rural Banks and Local Area Banks. CDs are subject to SLR and CRR requirement. There is no ceiling on amount to be raised by banks. Minimum maturity of CD has been reduced to 15 days w.e.f. 2000-01. Minimum size of issue has been reduced from Rs. 5 lakhs to

Rs. 1 lakh in June 2002 to be accepted from a single subcriber. Larger amounts have to be in multiples of Rs. 1 lakh. In 1992 other financial institutions like IDBI, IFCI etc. were permitted to issue CDs with maturity of 1-3 yrs. However, for banks , the maturity period is between seven days to one year.

(v) The Commercial Paper Market

The commercial papers were introduced in Indian money market in January, 1990. The commercial paper is issued by companies with a tangible net worth of Rs. 4 crores. Maturity of CP is minimum of 7 days and a maximum of upto one year from the date of issue. CPs can be issued in denominations of Rs. 5 lakh or multiple there of. CP issues are now delinked from working capital. The minimum credit rating shall be P2 of CRISIL or such equivalent rating by other approved agencies like ICRA or CARE. The CPs are issued at a discount to face value and the discount rate is freely determined. The purpose of CPs in Indian money market is to enable high level corporate borrowers to diversify their sources of short term borrowings on the one hand and provide an additional instrument to banks and financial institutions in the money market, on the other.

Problems Facing the Indian Money Market

Money market in India suffers from several defects, as a result of which it is not yet considered as a developed money market. Following are the problems facing this market.

1. Presence of unorganized sector of money market : The Indian money market comprises of several types of private lenders who are not under the control of RBI. Due to this, it becomes difficult for the monetary authority to regulate and implement its monetary/credit policies. This unorganized sector does not differentiate between short and long term finance, or even the purpose of finance. As such, they do not follow the credit policy of the RBI.
2. Seasonal Stringency of Money : The Indian money market suffers from seasonal stringency of money and the resultant high rates of interest. During slack season the banks have surplus funds and suffer as a result of dipping rates of interest. Hence money rates of interest fluctuate widely, adversely affecting the economy.
3. Near absence of Bill Market : A bill market is extremely useful for expanding credit. But despite efforts made by the RBI, the bill market in India is underdeveloped. This is mainly because till recently, banks had to keep large amounts of cash as statutory reserves. There is a general preference for borrowing rather than rediscounting bills and for cash transactions. An underdeveloped bill market also leads to shortage of funds. There is lack of standardization in drawing of bills and hundies in India.
4. Highly volatile call money market : This is another problem of the Indian money

market. The call money rates fluctuated from as high as 70 percent to 4 percent during 1990-91, although by 2005-06, the fluctuations had been considerably captured (between 8.25 percent and 3 percent). The high rates reflect the huge demand for short term funds by banks specially to meet their CRR requirements.

5. Inadequate money market instruments : The Indian money market does not possess an adequate and continuous supply of short term assets (i.e. money market instruments). As a result banks with surplus funds are unable to invest these profitably in the short period, and those who require short-term funds are unable to raise them.
6. There are few specialized dealers in short term assets in India who can act as intermediaries between the Government and the banking system. The establishment of Discount and Finance House of India in 1988 has solved this problem but only partially.
7. There is no co-ordination between the different sections of the money market as a result of which there are differences in the money rates in different sub-markets.

In its organisation and development, the Indian money market is not comparable to either the London money market or the New York money market. It suffers from a number of defects such as lack of integration because the organised and unorganised segments are working separately. The structure of interest rate is not rational due to the lack of adequate coordination between different banking institutions and policy of RBI. The bill market is not fully organised and there is shortage of funds in the money market. Moreover, there are inadequate banking facilities in India.

MAJOR REFORMS IN INDIAN MONEY MARKET

A systematic review of the Indian money market was undertaken by the Vaghul working group in 1987. Since then, a number of steps have been taken to improve the efficiency of the Indian money market. Some of these steps are as follows :-

1. Ceiling on call money rate has been withdrawn. All money market interest rates are, by and large, determined by market forces.
2. Selected institutions are allowed to borrow from the money market on a term basis.
3. The base of call money market has been widened by selective increase in the participants as lenders. Scheduled commerical banks (excluding RRBs), co operative banks (other than land development banks) and Primary Dealers and permitted to participate in call money market both as barrowers and lenders. The institutions who can only lend in call money market are- LIC, NABARD, UTI, mutual funds etc.
4. CDs were introduced in 1989, CPs in 1990, and guidelines relating to them are modified from time to time. Institutions like IDBI, IFCI and ICICI were permitted

to issue CDs with a maturity of one to three years.

5. A number of institutions have been set up like Discount and Finance House of India (DFHI), Securities Trading Corporation of India (STCI) to promote orderly development of money market. They are allowed to participate both as lenders and borrowers in the call money market.

   The DFHI was set up in January, 1988 jointly by the Reserve Bank, Public sector banks, and the All India Financial Institutions to deal in short term money market instruments, enlarge the number of participants in the call, short notice, and term money market by allowing financial institutions and mutual funds to participate as lenders. It moderates the volatility in the inter bank call money market by providing liquidity in the market as and when required. The STCI was set up on June 7, 1994 to develop an institutional infrastructure to act as base for an active secondary market in govt. dated securities and public sector bonds. It can also hold short-term money market assets like TBs.

6. Issue of adhoc 91 day TBs to finance the budget deficit of the government was discontinued, and a scheme of Ways and Means Advances (WMA) by the RBI to the Central Govt. was introduced with effect from April 1, 1997. Auction of 91-days TBs commenced from 1993. Also, TBs of various maturities have been introduced.

7. In April 1991, RBI announced the introduction bf Money Market Mutual Funds (MMMFs). The main objective was to provide small investors an investing opportunity yielding market related returns, help in broad basing money market by providing more participants, and help in mobilising household savings. The private sector was allowed to set up MMMFs in 1995. Also, UTI, IDBl, ABN Amro Bank and Bank of Madura Ltd. have been given clearance to set up MMMFs. Since March 2000, MMMFs have been brought under the purview of SEBI regulation.

8. The minimum lock-in period for money market instruments was brought down to 15 days.

9. Repurchase auctions (Repos) have been introduced since December 1992 in respect of Central govt. securities. If the banking system experiences liquidity shortage then RBI purchases govt. securities from banks and injects liquidity into the system. Since 1996 RBI has introduced Reverse Repos i.e. it sells govt. securities to banks to help them park their surplus funds. This policy of Repos and Reverse Repos is called Liquidity Adjustment facility (LAF) In Nov. 2005, RBI introduced a Second Liquidity Adjustment Facility (SLAF). First LAF operations are conducted in the forenoons while SLAF are conducted between 3.00pm and 3.45pm. However, the second LAF was abolished w.e.f Aug. 6, 2007. RBI also instituted a new margial standing facility (MSF) from which scheduled commercial banks can borrow overnight funds upto 1% of net demand and time liabilies.

10. A new short-term instrument known as Cash Management Bill (CMB) was introduced in May 2010 to meet the temporary cash flow mismatches of the Government. These are non standard, discounted instruments issued for maturities of less than 91 days.

Despite these reforms, the Indian money market is yet to acquire depth. Interest rates continue to be highly volatile. Moreover, the grand scheme of liberalisation and globalisation of money market has brought up many distortions without enhancing efficiency of institutions and allocation of resources. In our economy where the rural sector dominates, and the unorganised money market still plays an important role, money market reforms should start from reorganising rural financial structure.

Suggested Readings:

1.	L.M. Bhole	:	Financial Institutions and Markets
2.	Suraj B. Gupta	:	Monetary Economics: Theory, Institutions and Policy.
3.	Datt and Mahajan	:	Datt and Sundharam Indian Economy.
4.	Misra and Puri	:	Indian Economy.

Questions for Practice

1. Discuss the constituents of Money Market.
2. Write short notes on:
   - i. Problems of Indian money market.
   - ii Reforms in Indian money market.
   - iii Call money market
   - iv Commerical Paper market.

LESSON NO. 1.7 **AUTHOR : RAKESH KUMAR**

CAPITAL MARKET

Capital market is the market for long term funds, just as the money market is the market for short term funds. It refers to all the facilities and the institutional arrangements for borrowing and lending term funds (i.e. medium-term and long term funds). It does not deal in capital goods, but is concerned with the raising of money capital for purpose of investment. The demand for long term money capital comes predominantly from private sector manufacturing industries, agriculture, and from the government largely for the purpose of economic development. As the central and state governments are investing not only on economic overheads as transport, irrigation and power development, but also on basic industries and sometimes even consumer goods industries, they require a substantial sum from the capital market. The supply of funds for the capital market comes largely from individual savers, corporate savings, banks, insurance companies, specialized financial agencies and the government.

The capital market can be usefully divided into the primary market and the secondary market. The primary market deals with the selling of new securities when they are first issued by the issuing corporation. Since many of the initial buyers of these securities will eventually want to resell them, there is a secondary market for previously issued securities. The stock market, ·for example, is a secondary market in corporate securities.

THE PRIMARY MARKET

When a corporation decides that it wants to acquire new funds from the outside, it will frequently do so through the intermediation of an investment banker. Investment bankers are specialists in the marketing of new securities. They advise the corporations in the design of the security - what type of security should it be - common stock, preferred stock, or bond; if a bond, what rate of interest should it bear, what should be its maturity provisions, and so on - so that it will best serve the needs of the corporation and the buying public. Although there are a number of possible arrangements, the investment banking house will typically underwrite a new issue of securities. The investment house assumes a substantial measure of risk in an underwriting operation, large issues of new securities usually will be syndicated among several investment banking firms.

Many corporations engage in the private placement of securities. Private placement means that the issuer of securities sells them directly to the investors, without the underwriting services of an investment banker. This method of marketing new issues

has a number of advantages, foremost among these are that it is cheaper since underwriting costs are avoided.

THE SECONDARY MARKET

The secondary market in corporate securities can be sub-divided into two parts, the registered stock exchange and over-the-counter market.

(1) Stock Exchange:

Stock exchanges are voluntary associations of members who come together for the purpose of buying and selling, for the general public, the securities of the big corporations. Only certain securities are traded on the exchanges - the so-called listed stocks - and these are bought and sold by auction. Since the members of exchanges generally have branches throughout the country, the stock exchanges are truly a national market in which virtually anyone may participate.

(2) Over-the-Counter Market

The over-the-counter market is the market for those securities not listed on the stock exchanges. Used in the broadest sense, it includes all transactions' in securities, other than those taking place on the national stock exchanges. The over-the-counter market has very low entry barriers, and traders may range in size from very large houses doing international business, to one-person firms that trade only in local markets.

Economic Functions of the Secondary Market:

The role of secondary market is to make the primary market possible. Suppose, for example, a corporation needs to buy a machine with a life expectancy of twenty years. It may want to issue a twenty year bond to do this. But who would buy such a bond if they had it for full twenty years. With a secondary market, the initial purchaser of the bond knows that, if necessary, it can be resold to someone else in a year or two. In this fashion, the secondary market in securities is said to give liquidity to primary issues.

GOVERNMENT SECURITIES MARKET :

In most of developed and underdeveloped countries, large quantities of government securities are issued, to finance government operations and to re-finance maturing debt. This mechanism .is sometimes known as debt management. The treasury can issue new government debt instruments and sell them to financial institutions and general public. (These securities are not available to general public in most of the less developed countries).

These government securities can be of two types :

(i) Marketable government securities

(ii) Non-Marketable government securities

The securities that can be sold in the secondary market are termed as marketable securities and those that cannot be sold in the secondary market are known as non-marketable securities. The investors in government securities are the commercial banks,

LIC, GIC and provident funds. The latter are often compelled by law to invest a certain portion of their funds in these securities, and, therefore it is referred to as the captive market for government securities. This market is an over the counter market.

THE INTERNATIONAL CAPITAL MARKET

The central feature of such a market is that it makes possible the lending and borrowing of the funds in a currency outside the country of its origin. For example, it became possible for an Englishman, in London, to lend dollars to another Englishman in London. The capital market aspect of such a market is called the Eurobond market.

The Eurobond market is a market where bonds are denominated in a currency other than that of the country in which they are issued. For example, a French firm may engage a German investment banking syndicate to sell dollar-denominated bonds, and Italian and English investors may be the principal buyers of such bonds. It is particularly in this broader sense that Eurobond market is international in character.

CAPITAL MARKET IN INDIA

Indian capital market before independence could not develop, since there were few companies. Most of the British enterprises in India looked to the London capital market for funds. Individual investors were few and limited to the upper class in urban areas. Specialized issue houses could not develop in India and managing agency system performed to some extent the function of promotion, issue and underwriting of new capital issue.

Rapid expansion of the corporate and public enterprises since 1951 has necessitated the development of capital market in India. Indian capital market is divided into the gilt edged market and industrial or corporate securities market. The gilt edged market refers to the market for the government and semi-government securities backed by Reserve Bank of India. The securities traded in this market are stable in value and subscribed by the banks and other financial institutions. The industrial securities market refers to the market for shares and debentures of companies.

The government securities differ from industrial securities market in many important respects:

(i) More uncertainty regarding yield, management, addition to capital etc. is involved in industrial securities.

(ii) Financial institutions are compelled by law to invest a specified part of their demand and time liabilities in government securities.

(iii) The average value of the transactions in the government securities market is very much larger than in the case of shares and debentures of the companies.

(iv) Gilt edged market is 'over-the-counter' market.

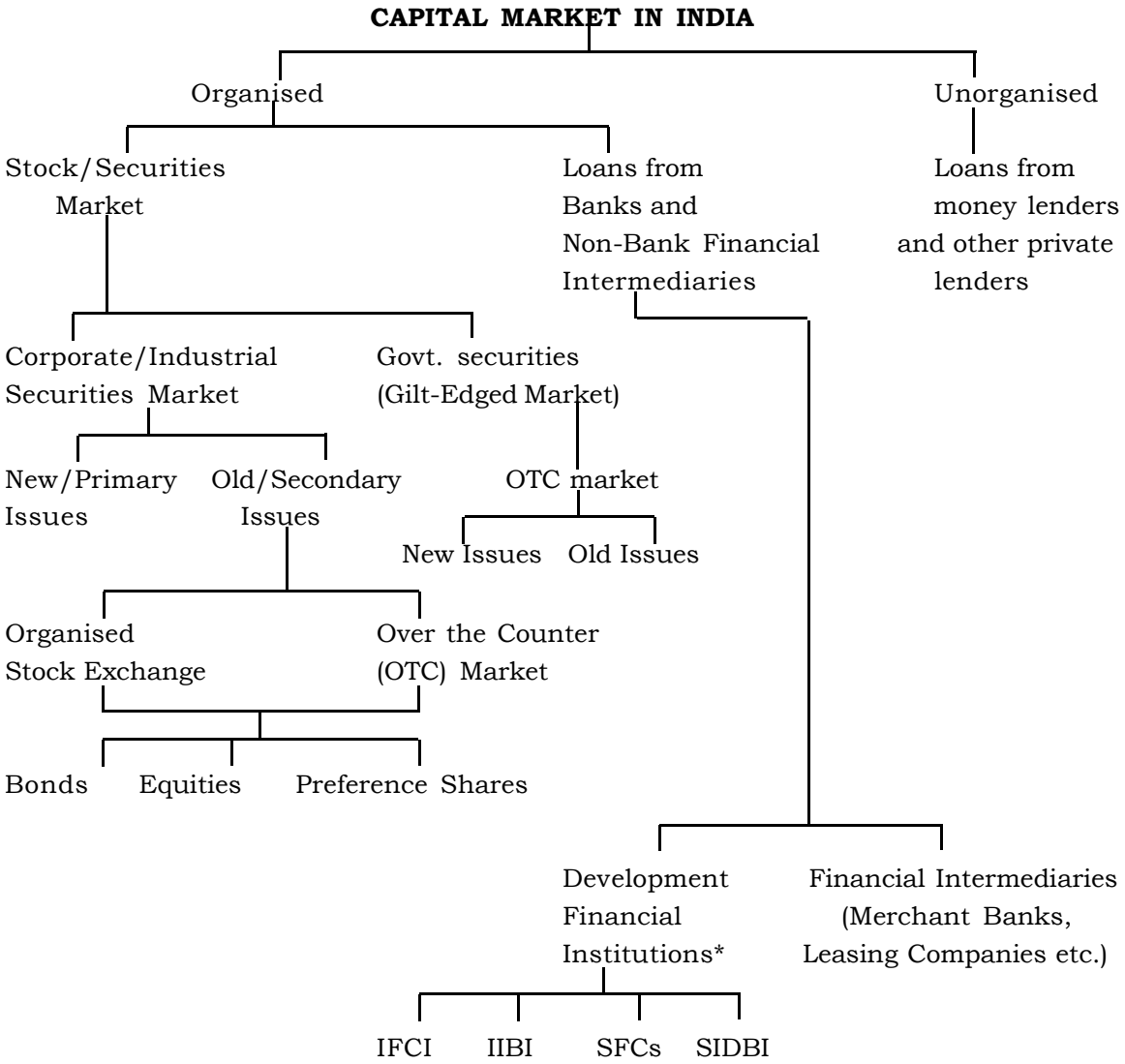
(v) RBI plays a dominant role in the gilt edged market through its open market operations.

Capital market, in India, started growing after independence. A very important

indicator of the growth of the capital market is the growth of joint stock companies or the corporate sector. The volume of capital market transactions has increased sharply; its functioning has been diversified. New financial instruments have appeared in the market.

Specialized financial institutions set up after independence to promote the industrial growth have been doing a useful work in subscribing to the shares and debentures of new and old companies, giving loan assistance, underwriting new issues and so on.

The following table will give us an idea about the structure of capital market in India:



* IDBI and ICICI are no longer included, as these are banks now.

The **stock/securities market** deals in long-term government and non-government securities.

The **corporate securities** are instruments for raising long-term corporate capital from the public. The **new issue market** arranges for the raising of new capital by corporate enterprises (old and new). It takes the form of equity shares, preference shares or debentures. The services of a network of specialized institutions is required to act as underwriters and stock brokers. In India, such institutions are ICICI, IDBI, GIC, LIC, UTI etc. There are three main ways of floating new issues: (a) by issue of prospectus to public (giving details about the company, issue, underwriters etc.); (b) by private placement with a few big financiers. This saves the company the expenses of public placement, and is also time saving; (c) by the rights issue to existing shareholders in a fixed proportion to their shareholding. Such an issue is usually offered at a discount from the going market price of the already trading shares of the company.

The **old issue market** deals in existing securities. It also acts as an indicator of investment climate in the economy. There are two segments of the old issue or secondary market – (a) the organized stock exchange, and (b) over the counter market.

The **stock exchange** is an organization for orderly buying and selling of listed (approved) existing securities; an association of persons or firms to regulate and supervise all transactions rules, regulations and standard practices to govern all market transactions, authorized stock brokers, and an exchange floor or hall where stock brokers or their authorized agents meet during fixed business hours to buy and sell securities. Only listed securities are traded on stock exchange. The listing (or approval) depends on size of issue, whether it is widely held by public, timely production of annual accounts etc*.

The **over-the-counter (OTC) market** deals in securities not listed on an organised stock exchange. These are securities of small companies and have only a limited market. Their prices are determined through direct negotiations between stock brokers and not through open bidding (as in the case of listed securities). OTC market was established in India in 1992. It operates at Mumbai with regional windows at other metropolitan cities.

The **gilt-edged market** is the market in government securities or securities guaranteed by the government. The latter includes securities issued by local authorities and autonomous government undertakings like banks, state electricity boards etc. The market is known as gilt-edged because these securities are of best quality and do not suffer from risk of default. Also, these are highly liquid. The Reserve Bank of India (RBI) manages the entire public debt of the central and state governments and keeps the market informed through recognized brokers about buying and selling price, keeping

* To be able to trade a security on a certain stock exchange; it must be listed on the respective stock exchange as per the guidelines issued by the exchange. Companies have to fulfill certain conditions before their securities can be traded on the stock exchange.

on ready sale securities of various maturities.

The **Development Financial Institutions** (DFIs) have lost much of their sheen due to the merger of IDBI with IDBI-bank, and that of ICICI with ICICI-bank. However a few DFIs are very briefly discussed below.

The **IFCI (Industrial Finance Corporation of India)** was established in 1948 for providing medium and long term credit to industry. It assists industries engaged in manufacturing, mining, construction, shipping and in generation and distribution of electricity. It also provides financial assistance to leasing and hire purchase concerns in corporate and cooperative sectors.

The **IIBI (Industrial Investment Bank of India),** initially known as Industrial Reconstruction Corporation of India (IRCI), and then Industrial Reconstruction Bank of India (IRBI), was set up to rehabilitate sick industrial units by tackling their technical, financial and administrative problems, and also providing a solution to labour management problems.

The **SFCs (State Financial Corporations)** are state level agencies for small and medium sized industries. The first SFC was set up in Punjab in 1953. The SFCs provide loans and advances upto 20 years. They also provide underwriting facilities and seed capital assistance.

Commercial banks are important constituents of the Indian capital market; but their operations have so far been confined to the purchase and sale of government securities. Their holding of industrial securities viz; shares and debentures are very small. In recent years, banks have been increasing their participation in term lending through subscribing to the shares and debentures of specialized financial institutions. They are also setting up financial subsidiaries to provide services as merchant banking, mutual funds, leasing companies etc. to mobilize funds from investment in industrial securities.

Merchant Banking :*

A few merchant banks have been set up by private financial service companies in association with foreign banking and money market institutions and some have been set up by firms and individuals engaged in brokerage and financial advisory business.

Merchant banks in India manage and underwrite new issues, they undertake syndication of credit, they advise corporate clients on funds raising and other financial aspects. Unlike the merchant banks abroad, Indian merchant banks do not undertake banking business viz. deposit banking, lending and foreign exchange services. In India, the merchant banks are subject to the regulation of SEBI.

---

* We have already studied about these in detail in semester III

Leasing and Hire Purchase Companies*

Leasing has proved a popular financing method for acquiring plant and machinery specially for small and medium-sized enterprises. Their growth is due to the advantage of speed, informality and flexibility to suit individual needs. The Narasimham Committee had recognised the importance and growing role of leasing and hire purchase companies in the financial intermediation process.

Mutual Funds*

Several public sector banks and financial institutions have set up mutual funds on a tax exempt basis, virtually on the same footing as UTI. They have attracted strong investor support and have shown significant progress. The government has now decided to throw the field open to the private sector and joint sector. At present, SEBI has the authority to lay guidelines and supervise and regulate the working of mutual funds. The guidelines issued by SEBI relate to advertisement and disclosure etc'. The investors have to be informed about the status of their investments in equity, debentures, government securities etc.

Venture Capital Companies*

There is significant scope for these in the context of emergence of technocrat entrepreneurs who have technical competence and expertise but lack financial capital. The technocrat entrepreneurs need the support of venture capital companies. The importance of venture capital companies is to give commercial support to new ideas and the introduction of new technologies. There is a high degree of risk involved in venture capital financing. Venture capital financing is one of the more recent entrants into the Indian capital market.

Apart from these, government of India has been instrumental in setting up a series of new financial intermediaries to serve financial needs of commerce and trade in the area of venture capital, credit rating and leasing etc. We refer to :

(i) Risk Capital and Technology Corporation (RCTC) which provides assistance in the form of risk capital and technology ventures,

(ii) Technology Development and Information Company of India Ltd, to sanction project finance to new technology ventures. (Now known as ICICI Venture Funds Management Co, Ltd.)

(iii) Infrastructural Leasing and Financial Services of India Ltd. to focus on leasing of equipment and infrastructural development.

(iv) The Credit Rating Information Service of India Limited (CRISIL) to undertake the rating of fixed deposit programme, convertible and nonconvertible bonds & debentures and credit assessment of companies.

(v) Stock Holding Corporation of India Limited to help in the transfer of shares, debentures and other securities by replacing the present system which involves

* We have already studied about these in detail in semester III

voluminous paper work.

All these institutions have been set up after the mid eighties and are of special importance for the Indian capital market.

Stock Exchange in India

For the existence of the capitalist system of economy and for the smooth functioning of the corporate form of organisation, the stock exchange is an essential institution.

The first organised stock exchange in India was started in Bombay when the Native Stock Brokers Association - now known as Bombay Stock Exchange - was formed by the brokers in Bombay. In 1894, the Ahmedabad Stock Exchange was started to facilitate dealings in the shares· of textile mills there.

The Calcutta Stock Exchange was started in 1908 to provide the market for shares of plantation and Jute mills. The number of stock exchanges rose from 7 in 1939 to 21 in 1945, under the Securities Contract (Regulation) Act 1956, the Government of India has so far recognised 15 stock exchanges. Mumbai is the premier stock exchange in the country and nearly 70% of all transactions in the country are done in that exchange.

Securities and Exchange Board of India (SEBI)

To overcome the shortcomings and drawbacks in Indian capital market particularly the defects of stock exchanges like weak managements and to regulate the capital market, the Government of India repealed Capital Issue Act 1947, abolished the office of the Controller of Capital Issues (CCI) and set up SEBI in 1988.

Initially, SEBI was setup as non-statutory body. In January, 1992 it was made a statutory body. SEBI was authorised to regulate all merchant banks on issue activity, lay guidelines and supervise and regulate the working of mutual funds and, oversee working of stock exchange in India. In 1995, SEBI was given more powers for the development of the capital market. It was empowered to file complaints in courts and to notify its regulations without prior approval of government. It was also empowered to impose monetary penalties on capital market intermediaries and participants on violations. SEBI has the power to summon attendance of and call for documents from all categories of market intermediaries. SEBI had made efforts to introduce practices and greater transparency in the capital market in the interest of investing public and the healthy development of the capital market.

CAPITAL MARKET REFORMS

(A) Primary Market Reforms : The following primary market reforms have been introduced :

1. Companies issuing capital in the primary market are now required to disclose all material facts and specific risk factors with their projects. SEBI has also introduced a code of advertisement for public issues for ensuring fair and truthful

disclosures.

2. To reduce the cost of issue, SEBI has made underwriting of issue optional, subject to the condition that if an issue was not underwritten and was not able to collect 90% of the amount offered to the public, the entire amount collected is to be refunded to the investors.
3. Merchant banking has been statutorily brought under the regulatory framework of SEBI. The merchant bankers have now a greater degree of accountability in the offer document and issue process.
4. SEBI has advised stock exchanges to amend the listing agreement to ensure that a listing company furnished annual statement to the stock exchanges showing the variations between financial projections and projected utilization of funds in offer documents and the actual utilization. This would enable shareholders to make comparisons between promises and performance.
5. The government has now permitted the setting up of private mutual funds and a few have already been set up. To improve the scope of investments by mutual funds, the mutual funds are permitted to underwrite the public issues.
6. Since 1992, the GOI allowed Indian companies access to international capital markets through dollar and Euro equity shares. GDR issues are also launched for the same purpose.
7. The government of India has also liberalized investment norms of NRIs so that NRIs and overseas corporate bodies can buy shares and debentures without the permission of RBI.
8. The requirement to issue shares at a par value of Rs. 10 and Rs. 100 has been withdrawn. But shares cannot be issued in the decimal of a rupee.
9. The Government has allowed Foreign Institutional Investors (FII), pension funds, mutual funds, investment trusts, assets or portfolio management companies etc. to invest in the Indian capital market provided they are registered with SEBI.

B. Secondary Market Reforms: Over the years, the following secondary market reforms were introduced in Indian Capital Market.

1. Three new stock exchanges at the national level were set up in the 1990s. These are Over the Counter Exchange of India (1992), National Stock Exchange of India (1994), and Inter-Connected Stock Exchange of India (1999).
2. The process of dematerialisation of securities through the depository system and their transfer through electronic book entry is pursued vigorously. For this, the National Securities Depository Ltd. (NSDL) was set up in 1996, and the Central Securities Depository Ltd. (CSDL).
3. Issuing companies are required to make continuing disclosures under the listing agreement. All listed companies are required to furnish to stock exchanges and

also publish unaudited financial results on a quarterly basis. Disclosure of material information is to be made available to public also.

4. Stock exchange has undergone major structural reforms. Boards of stock exchange have been made broad-based. Stock exchanges, brokers and sub-brokers have been brought under the regulatory purview of SEBI.
5. With a view to investigate' frauds in the stock market using a multi disciplinary team of experts, it has been decided to set up a serious Fraud office (SFO) in the Department of Company Affairs.

The government is arming SEBI with all necessary powers to control and regulate the securities market on the one side and effectively protect the interest of the shareholders on the other. To resolve the conflicts, of interest in the governance of various stock exchanges, new governance mechanisms with a separation between, ownership, management and trading rights has been evolved.

SUGGESTED READINGS

1. L.M. Bhole : Financial Institutions and Markets : Structure, Growth and Innovations
2. Datt and Mahajan : Datt and Sundharam Indian Economy (latest edition)
3. Govt. of India : Economic Survey (2012 onwards)
4. Suraj B. Gupta : Monetary Economics; Institutions, Theory and Policy

QUESTIONS FOR PRACTICE ONLY

1. Define a capitl market. Discuss its structure.
2. Discuss the reforms in the Indian capital market.
3. Write short notes on:
   i. Difference between money market and capital market.
   ii. SEBI.

LESSON NO. 1.8 **AUTHOR : DR. ANITA GILL**

BANKING SECTOR REFORMS IN INDIA

INTRODUCTION

As part of the process of liberalisation of the Indian economy, a number of reforms have been introduced, since mid 1991 in the financial sector. The main emphasis of the financial sector reforms has been on the banking system, since banks typically dominate the financial system in the early stages of financial development. The Indian banking system is passing through a crucial phase in the face of massive economic reforms undertaken by the Government of India. The financial sector reforms, aimed at bringing about free market economy in the long run, have already made their presence felt in the banking industry with the introduction of prudential norms.

In fact, the banking industry is heading towards a total commercial orientation under a liberalised free market environment and only those banks which are competitive and are capable of quickly adapting to changes are likely to make it global, and the rest may start assuming a regional or local character.

BACKGROUND

Before dealing with the reforms at length, it will be better if we look at the changes taking place elsewhere in the world, especially the global trends in banking. This would help us in understanding in a better way the reasons behind the reforms in the banking sector in our own country.

Banking in the major developed countries underwent revolutionary changes during the 1980s. A major factor responsible for these changes was revolutionary technological changes in computers and telecommunications. This led to innovations of new financial products. Improved telecommunications brought the countries closer, and financial markets across countries got integrated, resulting in what we call globalisation. Also, facing competition from non-banking companies, banks found their markets shrinking. To give more freedom to banks to face this competition, a process of deregulation was started. Banks now undertook hitherto prohibited activities while non-banking financial institutions (NBFIs) started undertaking some of the functions of banks. As a result, the distinction between commercial banks and other financial institutions started getting blurred.

Further, as the exposure of banks and other financial institutions to risks increased, it became necessary to maintain public confidence through transparency in financial statements, and an effective regulation and supervision of banking and non-

banking institutions.

Increasing global competition and risks of transactions also made it necessary to establish "a level playing field". The result was the Cook Committee Report on Capital Adequacy Norms for financial institutions in developed countries. These norms came to be adopted all over the world. Maintenance of the capital adequacy ratio necessitates frequent additions to capital funds, so achieving adequate profits became the primary goal of banking and other financial institutions.

BANKING SECTOR REFORMS IN INDIA

In India, changes were taking place as a result of the above mentioned global development, much before the famous Narasimham Committee. The Ghosh Committee Report (1985) on new formats of balance sheets, the Sukhmoy Chakravarty Committee Report on Monetary System (1985), the Vaghul Committee Report on Money Market (1987), and the establishment of the Discount and Finance House of India (1988) are milestones in the process of change. However, it was the crisis of 1990-91 which hastened the process of change. The international financial institutions (IMF and World Bank) lending funds to the country insisted on major changes in different areas including the financial sector as a precondition for loan assistance.

The Narasimham Committee Report (Report of the Committee on the Financial System) of 1991 can be said to be directed at Indianisation of the changes taking place elsewhere in the world. The Committee recommended wide ranging changes in the banking sector, which are being implemented in phases. In this lesson, we will concentrate on the findings and major recommendations of this committee, and then proceed to have a look at the present scenario of the banking sector in India. The second committee on banking sector reforms (1998) will also be studied and evaluated.

FINDINGS OF THE NARASIMHAM COMMITTEE (1991)

The committee was of the view that although the Indian banking sector has made commendable progress in achieving social goals (like extending the geographical reach and functional spread of banking services), this progress has been at the cost of decline in productivity and efficiency of the system. This has also resulted in the erosion of profitability of banks, raising serious doubts about their viability. This has adversely affected the ability of the system to expand further its range of activities. The committee was of the view that the basic causes of this low efficiency of public sector banks are the following :

1. Extensive Degree of Central Direction of their operations in terms of investment, credit allocation, branch expansion, etc. This relates to the problem of directed investment and directed credit programmes.

So far as **directed investment** is concerned, commercial banks in India have been required, as per the Banking Regulation Act of 1949, to maintain liquid assets in

the form of cash, gold, government securities etc. These should not be less than 25 percent of their total demand and time deposit liabilities. This is known as Statutory Liquidity Ratio (SLR). The RBI has sometimes stepped it up to as high as 38.5%, for an anti-inflationary effect. The committee was of the view that a higher SLR reduces the capacity of commercial banks to grant loans and advances to business and industry. This adversely affects the profitability of the banks, because the rate of interest received on government securities is less than the market related rate of interest. So SLR is, in fact, a tax on the banking system.

The committee was also of the view that the Cash Reserve Ratio (CRR), which is normally around 15%, also adversely affects the banks. This is because the rate of interest that the RBI pays on CRR is below the rate which scheduled commercial banks have to pay for one year deposits.

Combining the SLR and CRR, more than 50 percent of aggregate deposits of banks are locked up with the RBI or in government securities. This leaves very little for the banks to grant loans and advances and earn profits.

In case of **directed credit programme** the banks were asked to make purpose oriented lending instead of security oriented lending. 40% of the total bank credit was to be given to what came to be known as priority sector. The Narasimham Committee was of the view that this has further led to erosion of profits of the banks, as there was no proper loan appraisal of credit applications, no collateral requirements, and no post-credit supervision and monitoring. The stipulation that lending to priority sector will be at a concessional rate of interest, was based on the misconception that socially oriented credit should also be low cost credit. The committee felt that actually there is no need for interest subsidy which only reduces the ability of the banking system to build its strength and coverage.

2. Political and Administrative Interference : The Narasimham Committee was of the opinion that political and administrative interference in credit decision-making was the major factor for the decline of portfolio quality of banks. The committee cited the example of loan melas and distribution of IRDP loans, under which the "intended socially oriented credit degenerated into irresponsible lending." Apart from these, directions were given to banks to continue to extend credit to sick industrial units, as a result of which public sector banks suffered from lower income.

3. Mounting expenditure of banks : According to the Narasimham Committee, the public sector banks have been experiencing increasing expenditure. This is because there has been an increase in branch banking even where there was no need for it. This has also resulted in rapid growth of bank staff, but the quality of manpower has deteriorated. Remunerations are not related to productivity of the individuals or banks. and customer service has become increasingly inefficient. There have been increased

unreconciled inter-branch and inter bank entries. Besides, whereas the administering of bank credit to agriculture and small industry tends to be at higher cost, this type of credit is provided at subsidised rates of interest.

As a result of all these several public sector banks have become weak financially and are unable to compete in the changing financial environment.

The Narasimham Committee was of the view that whatever the cause of the poor profitability of banks, it was important that the situation be rectified and for this, the committee made some important recommendations, which are as follows.

RECOMMENDATIONS OF THE COMMITTEE (1991)

The main recommendations of the Narasimham Committee (1991) can be classified in the following areas :

1. Overall Monetary Policy Issues relating to interest rates and exchange rates, reduction in SLR and CRR ratios, modifications in refinance facilities, development of alternative system of monetary controls, etc.

The committee asked the government to reduce the SLR from the present 38.5% to 25% of the net demand and time liabilities of banks over the next five years. It also recommended that RBI should rely more on open market operations and less on CRR. CRR should be progressively reduced (to 10%) and RBI should pay interest on impounded deposits of banks above the basic minimum at a rate of interest equal to the level of banks' one year deposits.

The committee recommended redefining of the priority sector to include only the weakest sections of the rural community such as marginal farmers, rural artisans, village and cottage industries, tiny sector etc. Credit for this newly defined priority sector should be fixed at 10% of the aggregate bank credit instead of the present 40%. Also concessional rates of interest for priority sector loans of small sizes should be phased out, and subsidies in IRDP loans should be withdrawn.

The level and structure of interest rates should also be deregulated and determined by market forces. That is to say that all controls and regulations on interest rates on lending and deposit rates of banks and financial institutions should be removed.

The committee was of the view that easy and timely access to credit was far more important than its cost. Therefore concessional rates of interest for priority sector loans of small sizes should be phased out. The medium term objective was to move towards market determined interest rates. The RBI should aim at simplifying the structure of interest rates. It should be the authority to determine the level and structure of interest rates. It should use the bank rate as an anchor rate to signal changes in the direction and level of rates.

2. Measures for strengthening Banks : This was to be done by way of transparency in the financial statements of banks, cleaning up of balance sheets by way of prescription

of prudential norms for income recognition, asset classification and provisioning for impaired assets. The risk absorption capacity of banks was also to be improved by adopting prudential norms for capital adequacy.

The committee recommended that banks in India conform to the capital adequacy standards as prescribed by the Basle Committee on Banking Regulations and Supervisory Practices [appointed by the Bank of International Settlement (BIS)]. The BIS standard seeks to measure capital adequacy as the ratio of capital to risk weighted assets—the norm is 8 percent of the risk weighted assets. The committee recommended that all banks in India reach this figure in a phased manner, latest by March, 1996.

The committee was of the view that a proper system of income recognition and provisioning was fundamental in the preservation of the strength and stability of the banking system. Accordingly, a policy of income recognition should be based on record of recovery rather than on any subjective considerations. Interest on non-performing assets (NPAs) should not be looked as income on accrual basis. The NPAs are to be defined as an advance where, as on the balance sheet date :

(a) in respect of term loans, interest remains past due for a period of more than 180 days.

(b) in respect of overdraft and cash credits, accounts remain out of order for a period of more than 180 days.

(c) In respect of bills purchased and discounted, the bill remains overdue and unpaid for a period of more than 180 days.

(d) in respect of other accounts, any amount to be received remains past due for a period of more than 180 days.

An amount will be considered past due when it remains outstanding 30 days beyond the due date (i.e. it is the grace period of one month after it has become due for payment by the borrower).

For the purpose of provisioning, banks and financial institutions were to classify their assets into the following groups :

(a) Standard

(b) Substandard

(c) Doubtful

(d) Loss

The definition of such assets and extent of provisioning required was to be as follows :

Asset Group	Definition	Extent of Provisioning
Standard	Loans in order and those with irregularity for less than 180 days.	Nil
Sub-standard	Assets classified as non-performing* for a period not exceeding two years	10 percent of the total outstanding.
Doubtful	NPAs which remain as such for a period exceeding two years and loans in respect of which instalments are overdue for a period exceeding 2 years	100 percent of the security shortfall and 20-50 percent of even the secured portion.
Loss	Accounts where loss has been identified but the amount has not been written off.	Entire assets should be written off, or 100 percent of the outstandings should be provided for.

In addition to the proper procedures for income recognition, provisioning and maintenance of capital adequacy, the committee recommended greater transparency in the financial statements of banks.

To deal with that portion of the portfolio of banks which had already become bad and doubtful, the committee recommended that these assets were to be taken off the balance sheet of banks and institutions. It recommended the setting up of a separate institution by the government of India, to be known as Asset Reconstruction Fund (ARF) with the purpose of taking over such assets from banks and financial institutions and subsequently following up on the recovery of the dues owed to them from the primary borrowers. The share capital of this fund could be subscribed to by the government of India, the RBI, public sector banks and financial institutions.

3. Recommendation regarding structural organisation of the banking system: The committee put forward the broad pattern towards which the banking structure should evolve. It was—

(a) 3 or 4 large banks (including the State Bank of India) which could become international in character.

(b) 8 to 10 national banks with a network of branches throughout the country;

(c) Local banks confining their operations to specific regions.

(d) Rural banks (including RRBs i.e. Regional Rural Banks), where operations would be confined to the rural areas and these would be primarily in financing of agriculture and allied activities.

The committee also recommended freedom of entry into the financial system and

* With effect from 2004, the duration for treating an asset as NPA has been reduced to 90 days.

establishment of new banks in the private sector (provided they conformed to the minimum start up capital and other requirements and the set of prudential norms.) The committee also proposed that there should be no further nationalisation of banks so as to remove the existing disincentive for the more dynamic private sector banks to grow. Further, joint ventures between foreign banks and Indian banks should not only be permitted, but be actively encouraged. The committee felt that the entry of foreign banks into the country would have a beneficial impact from the point of view of improving competitive efficiency of the Indian banking system, as also upgrading work technology.

The committee also proposed that the system of branch licensing should be discontinued and Indian commerical banks should be given full freedom to open or close branches (other than rural branches) or swap their rural branches with those of other banks on the basis of their commercial judgement.

4. Measures regarding regulation and supervision of banks : The committee believed that the regulation of the financial system is a must, and it should cover the essential aspects of protecting the quality of assets. But the committee recommended ending of the duality of control over the banking system between the Reserve Bank and the Banking Division of Ministry of Finance. The Reserve Bank should be the primary agency for the regulation of the banking system.

The committee also suggested that the supervisory function be separated from the more traditional central banking functions of the Reserve Bank. For this end, a separate agency which could be quasi-autonomous called Banking Supervisory Board under the aegis of the Reserve Bank be set up. The Board could have a membership of five and be composed of professionals from areas such as banking, development finance, accountancy, law, management and have a representative of the government. Also, the government and other government departments should not deal directly with the banks and financial institutions but do so only through the Ministry of Finance which in turn would do so through the Reserve Bank.

In short, the Narasimham Committee more or less blamed the Government of India and the Finance Ministry for the sad state of affairs of banks.

AFTERMATH SCENARIO

The Narasimham Committee had made recommendations which were quite revolutionary. These were strongly opposed by bank unions and leftist parties. But despite stiff opposition, the Government of India accepted all the major recommendations of Narasimham Committee. The following measures were taken as part of implementation of the recommended banking sector reforms :

(i) Statutory Liquidity Ratio (SLR) was reduced from 38.5 per cent to 25 per cent of net demand and time liabilities. This was achieved in 1997.

(ii) Cash Reserve Ratio (CRR) was also brought down, which resulted in (in

1997) releasing Rs. 18000 crores of cash balances to the banks to be used for lending to various sectors of the economy.

(iii) Interest rate slabs were gradually reduced from 20 to 2. Scheduled commercial banks now have the freedom to set interest rates on their deposits subject to the minimum floor and miximum ceiling rates. Freedom has also been given to offer all loans on fixed or floating rate basis.

(iv) Prudential norms regarding income recognition, classification of assets and provisioning of bad debts, were implemented. Besides, capital adequacy norms were also fixed.

(v) New private sector banks have started functioning. Also, commercial banks have been given the freedom to open new branches and upgrade extension counters. Bank lending norms have been liberalised. Since 1996-97, local area banks have been set up in A.P., Karnataka, Rajasthan, Punjab and Gujarat.

(vi) Supervision of commercial banks is being tightened, and a Board of Financial Supervision has been set up. RBI has also established in 1993 a new department known as Department of Supervision as an independent unit for supervision of commercial banks and to assist the Board of Financial Supervision.

(vii) Special Debt Recovery Tribunals have been set up since 1993 at Kolkata, New Delhi, Jaipur, Ahmedabad, Bangalore and Chennai to facilitate quick recoveries of loan arrears.

(viii) Nationalised banks have access to capital market for funds through public issues, provided holding of Central Govt. would not fall below 51 percent of paid up capital.

However, while the financial sector reforms have improved the viability and competitiveness of public sector banks, there have been **criticisms** of the reforms as well.

According to N.A. Mujumdar*, two basic features of the reforms measures need to be highlighted— (1) The reforms are no more than the adoption of a mimetic concept of the modernisation of the financial sector, regardless of its relevance to the conditions prevailing in India. The result is that only, 'ghosts' of such institutions exist today. Also, undue importance has been given to developing these institutions, and in the process core issues like improving the rural credit delivery system, have been put on the "back burner."

---

* N.A Mujumdar (1996), "Financial Sector Reforms : An Exercise in Introspection", *Economic and Political Weekly,* Vol. XXXI, No. 12, March 23.

(2) The second feature of the reforms is the new found faith in the markets. The reform measures are blindly depending on market forces. But even American economists have recognised that there exist forms of government intervention that will not only make financial markets work better but will also improve the performance of the economy.

Mujumdar has further pointed out that although the priority sector target of 40 percent of net bank credit has not been officially reduced (as recommended by Narasimham Committee), banks have willingly reduced it to around 33 percent. Besides, interest rates have reached usurious levels, making things worse for agriculture and small scale industries. Apart from this, priority sector has been redefined to include such items and advances which are not meant for the small and marginal farmers (for e.g. advances for buying pick up vans).

Besides, restructuring of RRBs as recommended will serve no purpose as these account for only about 10 percent of institutional credit to the rural sector. Rural population at large is still being exploited by usurious money lenders. Thus, though the banking sector reforms have not seriously derailed the system, the social commitments of the sector have been hit seriously. And the most obvious example is the rural credit system.

Questions have also been raised regarding the capital adequacy norms. It has been pointed out that while capital acts as a cushion against unforeseen losses, the capital adequacy ratio does not capture the quality of assets, and thus does not reveal the true strength of a bank. Meeting capital adequacy is not enough when NPAs are high. Thus, in focussing too narrowly on capital alone, as a measure of bank health, there is a danger of overlooking other important aspects of a bank's well-being.

NARASIMHAM COMMITTEE ON BANKING SECTOR REFORMS (BSR)—1998

The (second) committee on BSR was once again chaired by Mr. Narasimham, and it submitted its report in April 1998. This committee was formed to review the progress of the banking sector reforms to date, and also to chalk out a programme on financial sector reforms to strengthen the financial system of the country.

The main recommendations of this second committee were as follows :

(i) **Need for a stronger banking system :** The committee on BSR (1998) recommended the merger of strong banks, but cautioned against the merger of strong and weak banks as this may negatively affect the asset quality of the stronger bank. The committee was also of the view that two or three large Indian banks be given an international character.

(ii) **Narrow banking :** This means that the weak banks place their funds only in short term risk free assets. If this practice did not rehabilitate the weak banks, then these should be closed down. However, in the budget

speech of Finance Minister in 2000; it was declared that no more banks will be closed down.

(iii) **Small, local banks :** The committee suggested that while 2 or 3 banks should be international in character, 8-10 large national banks should take care of the needs of large and medium corporate sector, there should be small, local banks which should be confined to states or cluster of districts in order to serve local trade, small industry and agriculture.

(iv) **Capital Adequacy Ratio :** The committee suggested a capital adequacy ratio higher than the one previously prescribed i.e. to raise it from 8 per cent to 10 per cent. It also suggested setting up of an Asset Reconstruction Fund (ARF) to take over the bad debts of banks.

(v) **Shareholding of banks :** The committee recommends that the minimum shareholding by government/RBI in the equity of nationalised banks and the State Bank of India be brought down from 51 percent to 33 percent. Public sector banks should also be encouraged to approach the market for raising resources.

(vi) **Rural credit institutions :** The committee recommended that the dual control over co-operative credit institutions by the state government and RBI/NABARD be eliminated and all co-operative banking institutions be brought under the Banking Regulation Act under the aegis of RBI/ NABARD.

EVALUATION OF THE BSR REPORT OF 1998

It has been pointed out that there was actually no need of setting up a second committee on banking sector reforms even before a decade of the recommendations put forward by the first committee. The second committee has even been labelled as an "action replay" of the first committee.

The shortcomings of the second committee have been mainly pointed out by N.A. Mujumdar in his article published in Economic and Political Weekly (Vol. XXXIII, No. 47 and 48, Nov. 21-27/28, Dec. 4, 1998; pp. 2954-2957). He is of the view that the growth perspective is missing from the major recommendations of the committee of 1998. In an attempt to cast the Indian banking system in the image of American banking, the report has lost sight of India specific issues.

It has been argued that political meddling and bureaucratic stranglehold have not allowed a healthy growth of public sector banks. NPAs in banks are more a result of loan 'melas' and write offs of debts, and not due to the inefficiency of bankers. Besides, the bureaucratic stranglehold has given rise to a culture where 'pleasing the bosses' is more important than professional competency.

Regarding the setting up of ARF, it has been pointed out that it would be better if

each public sector bank was provided with an additional executive director for a period of around three years to clean up the NPAs.

The most conspicuous weakness of the BSR report is its failure to diagnose the core problem currently being faced by the public sector banks—they have become largely dysfunctional virtually abdicating normal banking responsibilities. This explains why banks have high liquidity, but at the same time demand for credit is largely unsatisfied.

Thus, it is necessary that RBI tackle such issues.

CONCLUDING REMARKS

It can be said that the BSR Committee report of 1998 is no different from the Report of the committee on Financial System of 1991. However, while the earlier report had practically ignored rural credit, the BSR report has devoted attention to rural and small industries credit. But both committee reports suffer from serious drawbacks. This is mainly because of the reason that these have not taken into account issues that are specific to India, but have merely attempted to promote ideas which may be good for developed countries, but not necessarily beneficial for countries like India.

Suggested Readings

1. Report of the Committe on Financial System 1991
2. Datt and Mahajan: Datt and Sundharam Indian Economy
3. N.A. Majumdar: "Financial Sector Reforms: An Exercise in Introspection", Economic and Political Weekly, Vol. XXXI, No. 12, March 23, 1996

Questions for Practice

1. Discuss the main recommendations of the Narasim Committe Report 1991
2. What were the main findings of Narasimham Committe Report 1991?

LESSON NO. 1.9 **AUTHOR : DR. ANITA GILL**

REGULATION OF BANKING SYSTEM
(FREE-BANKING THEORY)
OR
(LAISSEZ-FAIRE BANKING)

INTRODUCTION

We have already studied about central banks, the important functions that they perform, and the instruments that are used by these banks to control the supply of money in the economy. All along, we had been emphasizing the important role played by central banks in stabilizing the monetary system. Even today most people take it for granted that banking is inherently unstable, and the banking system needs a lender of last resort (i.e. a central bank) to defend it in crisis; and the value of currency has to be protected by the government.

However, slowly but surely, there has arisen a new interest in issues of financial regulations and central banking. The idea of free (or laissez-faire) banking has enjoyed a remarkable renaissance in recent times. It is being increasingly felt that free trade in the financial services sector is desirable. And "the whole panoply of government intervention into the financial sector—the central bank, government sponsored deposit insurance and government regulation of the financial system—should all be abolished." On the other hand, some economists like George Benston and George Kaufman, Shiela Dow etc. still justify financial regulation and government intervention and hence dismiss ideas regarding free banking.

In the present lesson, we shall be concentrating on this **controversy** : Should the financial system be regulated, or should there be free banking—i.e. no government intervention and no central banks! Three different views on the regulation of the financial system will be presented here. While **Kevin Dowd** offers a 'free banking' perspective on the subject, and challenges the justification for any form of state regulation in banking, **Benston and Kaufman** argue for a limited, but nonetheless positive role for government intervention. The third view, put forward by **Shiela Dow**, argues for a much more extensive regulation, and dismisses free banking as unworkable in practice.

While presenting Dowd's views, we will also give a description of how Dowd visualizes the evolution of a free banking system beginning from a primitive economy. Dowd argues that with no state interference to hinder it, this evolutionary process would lead to the development of a highly sophisticated free banking system.

Apart from Kevin Dowd, David Glasner and George Selgin have also explored the theory of free banking, and reached broadly similar conclusions. Hence, in the present lesson, we will be considering Kevin Dowd as representing the views of all those who favour free banking.

KEVIN DOWD'S VIEWS: EVOLUTION AND WORKING OF FREE BANKING SYSTEM

Dowd argues (along with other 'free bankers') that there is nothing distinctive about money or banking that makes the financial services sector an exception to the general rule that free trade is best. According to him, government intervention in the banking system is not only unnecessary, but essentially counter productive.

To support his argument, Dowd starts from an initial primitive state of society, and suggests how a banking system would evolve in the absence of state intervention. According to him, the **various stages of the evolution of a free banking system** are as follows :

1. The Development of Coins

In a relatively primitive society, when individuals begin to trade with one another, there would arise the problem of coincidence of wants. To avoid this problem, people will resort to 'indirect exchange' by accepting a popular intermediate good, but there would still be a problem of measuring the quantity of goods they were offered and assess their quality. Historically, people have tended to converge on the precious metals as desirable intermediate goods.

However, the use of precious metals as intermediate goods would involve the problem of weighing lumps of metal and assessing their purity. As a solution, some individuals would start acting as intermediaries and make a living out of assessing the purity of the metal brought to them and recasting it into pieces of more convenient size. With the spread of such practices, the fineness and sizes of metal pieces would gradually become standardized and the private people would be attracted to this business, and this would lead to intermediaries using distinctive mints, and their pieces would become privately issued coins.

Each of these private mints would exist primarily to maximize its own profits. Dowd is of the view that these mints would have no incentive to cheat by overstating the weight of their coins, because such a deception would be easy to detect. This would harm the mint's reputation and its business. Also, this would be a legal offence.

Dowd considers it important to point out at this stage that the governments have intervened in the monetary system, and used their coercive powers to create a legal monopoly in the minting business. The government could also impose high minting charges or misrepresent the weight of the coins it issued. But it could still stay in business, as it had legal monopoly.

But let us leave this point, and go on to discuss the next stages in the evolution of

free banking.

2. The Development of Banks issuing Convertible Notes

The privately issued coins would solve the difficulties of a barter system, but there would still be the problem of storing these coins, and moving coins around. To avoid storage costs, some people would be prepared to pay others who already had the facilities (safes and strong boxes) to keep gold safe, to store their coins/gold for them. Hence goldsmiths or merchants (who kept large amounts of gold and silver) would be asked to look after other people's gold, in return for a fee. Also, the depositors would obtain receipts from those holding their gold or silver coins, attesting to the value of each deposit.

Now it would so happen, that when two people agreed on an exchange, one would go and withdraw his coins and hand them over to the other, who would deposit them again. But it would be more convenient that the party accepting payment simply accepted the goldsmith's receipts and save both parties the bother of visiting their goldsmiths.

Hence, goldsmith's receipts would begin to circulate as a medium of exchange in their own right (we can call these the equivalent of present day 'cheques'). At the same time, the goldsmiths would begin to notice that only a small proportion of their deposits of gold would be demanded in redemption over any given period. They would realize that they could safely lend out some of the gold deposited with them and face little danger of being unable to meet their liabilities. This lending activity would also give them an opportunity to earn additional profit.

The goldsmiths would thus become bankers—accepting deposits, and lending money. To stay in business, they would compete with each other for deposits. This could be done by offering interest in deposits (instead of charging fee from depositors for the safe keeping of their money). They can also compete for deposits by offering guarantees to prospective depositors that the receipt notes issued by them would retain their value. And this guarantee could be given by promising to convert their notes back into specie/gold and silver coins. These guarantees would have the status of legally binding contracts.

Dowd feels that this commitment to convertibility is one of the most important features of a free banking system. It would help ensure that the bank notes remained relatively stable in value. Also, the commitment to convertibility would provide an effective discipline against (goldsmith) bankers who issued an excess of notes. This is because the circulation of convertible notes would be limited by the demand to hold them. And this demand would depend upon the convertibility contract, the bank's reputation, etc. Any notes issued in excess of demand would be returned to the bank for redemption so a bank would not deliberately choose to issue an excess of notes, because they would not remain in circulation long enough to justify the expense of

putting them into circulation and then taking them back again.

In this way, Dowd has expelled the fear that there would be an over issue of currency notes if the government/central bank is not given the monopoly right of note issue.

3. The Development of Note Clearing

The next stage in the evolution of the banking system would be the development of a note clearing system that would arise out of the banker's attempts to raise their profits by increasing the demand for their notes. Of course, in the beginning no banker would accept the notes of other banks when such notes were submitted by the public, because this would make the rival bank's notes more acceptable. But any two banks could make themselves jointly better off by agreeing to accept each other's notes. Each bank would benefit, because the public would more readily accept the notes of either of the two banks, given the knowledge that the other bank would accept the notes as well. Thus additional bank pairs would be formed, and it would become increasingly apparent that the easiest way to organize the note exchange system would be to meet regularly at a central clearing session where the banks would hand back each others' notes and settle the differences. In this way a central clearing system would evolve out of the bank's own private self-interest.

The clearing system would provide a further restraint on the ability of any one bank to over issue its notes. This is because a bank issuing more notes than public demand would face reserve losses not only from the public directly, but also at the central clearing sessions, where other banks would return the extra notes to the issuing bank.

4. The Development of a Liquidity Market

The note convertibility and the central clearing system would significantly stabilise the monetary system. However, any bank can still face a problem of liquidity, given its ability to redeem only a fraction of its liabilities at any given time. With sufficient advance notice, of course, a sound bank would be able to meet demands for redemption, but a problem could arise in case it failed to receive advance notice.

Dowd is of the opinion that two institutions would develop to deal with the problem. The first would be the growth of a market in short-term liquidity. At any given time some banks would find themselves with more liquidity than needed, while others would have less liquidity than demanded. Those with excess reserves would be willing to lend them out on a short-term basis, while those that were short of reserves would be willing to borrow them, making both groups better off. And experience would teach the lending banks what kind of collateral policy to be adopted, what practices are to be followed etc.

5. The Development of Option Clauses

Even with the development of a liquidity market, there might arise problems because the banking system as a whole might not be able to obtain the reserves needed from the liquidity market, even though any individual bank could. Thus if there is an unexpectedly high demand for cash, and the short term liquidity market dries up as a result, the banking system might collapse.

This problem can be avoided if, instead of guaranteeing to redeem their notes for specie on demand, the banks could reserve the right to defer redemption for some pre-specified period. Of course, the note holders should have some pre-specified compensation from the banks when the notes were finally redeemed. In other words, the bankers could insert clauses (option clauses) into the convertibility contract, so that banks may have the option of deferring redemption.

The option clauses would have to be carefully designed, so that the public is assured that its notes were still safe. The option should be used only in exceptional circumstances, and for this the bank should set the compensation paid to noteholders at a high enough level.

Trial and error would determine the period over which redemption could be deferred and the interest to be paid on notes whose redemption had been suspended.

In this way, Dowd has visualized the evolution of a laissez-faire banking system. According to him, institutions like convertibility, a clearing system, a market for short-term liquidity and option clauses would develop and protect the banking system against shocks. The driving force behind these stabilizing mechanisms would be individuals' self interested attempts to protect themselves against adverse conditions. Thus, this type of free market monetary system would be highly stable.

To further strengthen his point that a free banking system would be stable, Dowd argues that with no lender of the last resort or state run deposit insurance system, bank managers would understand that their long-term survival depended on their ability to retain their depositors' confidence. They would therefore pursue conservative lending policies, submit themselves to outside scrutiny, and publish their audited accounts. They would also provide reassurance to their customers by maintaining adequate capital.

Dowd also brushes aside the frequently given argument that competitive pressures produce instability by forcing 'good' banks to go along with the policies of 'bad' banks. If bad banks expand rapidly, they can make easy short-term profits, which pressurise the managers of good banks to expand rapidly as well, with the result that the banking system as a whole cycles from boom to bust and becomes unstable. However, Dowd does not agree with this. He says that if a bank believes that its competitors are taking excessive risks, the most rational course of action is for it to distance itself from such banks, and build up its financial strength further. This bank is then strongly placed to win over their customers and increase its market share (when other banks start to

suffer losses and lose confidence). The bank would have to forego short-term profits, but it would win out in the long-run. Thus competitive pressures would not force free banks into excessive cycling and instability.

Dowd has also considered the impact of state intervention in the free banking system. State intervention in banking is normally taken to mean the establishment of a central bank to serve as lender of last resort (LLR) and the establishment of a state sponsored system of deposit insurance. Dowd feels that LLR only protects bad banks, and tried to keep weak banks open, since good banks can always obtain loans to maintain their liquidity. But the existence of LLR reduces the incentives for good banks also to adopt the virtuous strategy of building themselves up. And so even the good banks may decide to take greater risks in anticipation of LLR protecting them from any crisis. Thus, ironically LLR produces the very instability that proponents of central banking often claim would arise under free banking. The same is the effect of a system of deposit insurance. Dowd feels that deposit insurance encourages undue risk taking by banks and reduces their financial health.

To conclude, Dowd is of the opinion that the conventional view that free banking system cannot be stable should be rejected. According to him laissez-faire banking is the best.

THE VIEWS OF BENSTON AND KAUFMAN

Benston and Kaufman argue for a limited, but positive, role for government intervention. They argue that most of the arguments which support bank regulation are not supported by either theory or empirical evidence. But they also argue that banks should be regulated prudentially, and this regulation should be mostly in the form of capital adequacy requirements.

Benston and Kaufman do not fully disagree with Dowd regarding his views on free/laissez-faire banking. This is apparent when they cite the example of United States, where bank failure rate was lower until the establishment in 1913 of the Federal Reserve system. The failure rate increased only after the establishment of a central bank (which actually was set up to reduce the severity of bank crises). However, instead of building up a case in favour of free banking, Benston and Kaufman focus on how banks should be regulated in the existing non-laissez faire structure of banking.

According to Benston and Kaufman, the most important justification for government imposed regulations is the presence of externalities. According to them, a positive externality might be production of a commonly accepted and efficiently used medium of exchange and store of value. In the negative externalities are included avoiding of contagious bank runs on solvent banks; avoiding economic collapse as a result of bank failure; and reduction of the costs imposed on prudently run banks and taxpayers of government provided deposit insurance.

They concluded that governmentally provided bank safety does not yield a substantial positive externality, even if this regulation were effective. But if one fears loss of positive externality from the public's use of private bank money, one should be concerned with the operations of the central bank.

Moreover, once a government has given in to demands for deposit insurance, it is politically difficult to withdraw or reduce it. Further, now that deposits are held by almost everyone in most developed countries, it has become increasingly difficult for govt. officials to refuse to bail out depositors in failed banks. Thus government deposit insurance is a must.

To conclude, Benston and Kaufman essentially agree with Dowd's laissez-faire position, but opt for regulation that works in a way free markets would operate. They also accept the existence of government owned central banks, although they agree that private central banks may do less harm to the economy.

Dowd, however, has pointed out that Benston-Kaufman miss an important point that the choice is not to be made between government and private deposit insurance, but between government deposit insurance and free banking scenario, in which banks provide implicit insurance through strong capitalisation.

THE VIEWS OF SHEILA DOW

Shiela Dow argues for extensive regulation because of "the special economic role of money and the uncertainty associated with it." According to her, free banking is essentially unworkable in practice.

Sheila Dow advances two principal arguments against free banking. The first is that free banking produces excessive cycling from which she concludes that there is a need for a central bank to stand above the market processes and take corrective actions against excessive cycling. Her argument rests on a underlying post-Keynesian view of the uncertainty attached to valuing bank assets. Free banking proposals rest crucially on the market's capacity to value bank assets. In the absence of state regulation and supervision, it is the market which is to discipline banks into adopting prudent portfolios. Yet, S. Dow says, free bankers have not demonstrated that the market can actually generate the knowledge by which to assess bank risk. Free banking would certainly provide the incentive to depositors to acquire more information about banks, but the question is whether even complete information is adequate for correctly assessing risk with respect to asset values.

Dowd has objected to the above views of Shiela Dow. He says that there is little evidence of excessive cycles (from boom to bust) under historical free banking system. He says historical record has suggested that real-world intervention has destabilised the financial system rather than stabilising it. Also, if assets are so difficult to value (as Dow says), then how can central bankers be expected to know where the private bankers

are going off the rails. And if they do not know, they cannot avoid cycles.

Shiela Dow has also opposed free banking for another reason. She argues that free banking is pointless because central bank would emerge spontaneously from it. This is because the requirement of a credit based economy produces a degree of centralisation of power that is effectively the same as central banking. When there is a crisis in free banking, there is a scramble for safe assets. The issuer of this safe asset then becomes a de facto central bank.

Kevin Dowd has once again countered this argument by saying that even if there is a scramble for assets, it does not follow that such assets are issued by one institution only. Also, historical free banking suggests that there is always more than one 'big' bank, and it is wrong to assume that there is only one key institution in the free banking system.

Notwithstanding this, Sheila Dow is against complete deregulation of banking. According to her, the special characteristics of money make the monetary system a public good, and the uncertainty associated with it means that financial laissez-faire, if ever implemented, would at best give way to its own form of central banking. The instability of the banking system justifies the existence of central banking and bank regulation. Thus, she says, what is called for is not deregulation, but better regulation.

CONCLUSION

We have presented above three views regarding free/laissez-faire banking. While one view is completely in favour of deregulation/free banking (Kevin Dowd), the second view favours a limited role of government intervention (Benston and Kaufman), while the third view is entirely against free banking (Sheila Dow). Kevin Dowd has also effectively built up counter arguments against the latter two views, and also given a clear description of how a free banking system might evolve.

However, it needs to be seen that how far such a free banking system would work effectively in developing countries like India. The socio-economic needs of a country, which is grossly over-populated, and where the basic needs of a sizeable portion of population are yet to be fulfilled, the idea of implementing complete laissez-faire in the financial system seems implausible. In such countries it is essential that social objectives be placed higher than economic objectives. Nonetheless, India has partially moved towards this direction since the 1990s, when it undertook the structural adjustment programme, and made an attempt to 'reform' (read liberalise) the financial system on the recommendations of the Narasimham Committee Report. The success achieved has been limited. In fact, what is called for here is the provision of cheap, adequate and timely credit to sectors vital for economic development. A completely free system of banking will obviously not fit into this role, as it will be profit-oriented. Hence, some regulation and state intervention is a must in a country like ours. Social objectives will

have to be placed higher than profits till a time our economy reaches a stage of development at par with countries like U.S. Till then, complete laissez-faire in banking will do more harm than good. In fact, research has also suggested that leave aside laissez-faire banking, even the establishment of an independent central bank (i.e. a central bank that is not subordinated to the government) will not be of much use in less developed countries with shallow financial markets. Central bank independence should be granted after a country has attained financial sector development. And laissez-faire banking should be considered only after this stage.

Shadow Banking

Shadow banking refers to bank-like operations (mostly lending) that take place outside the conventional banking industry. Internationally, it is now frequently referred as a market-based finance or non-bank financial intermediation. The purpose of the traditional bank lending and shadow bank lending are identical. However, it is not subject to the same regulations as conventional bank lending.

Examples of entities that engage in shadow banking are:

- Bond funds
- Money market funds
- Finance companies
- Special purpose entities.

Working of shadow banking

In the case of conventional lending, a bank's capacity to lend is determined by the amount of deposits it receives and the amount it can borrow from the markets. Same principles apply to the shadow banking. For example, an investment fund takes in money from investors, issuing shares in the fund in return. Just as the bank acts as the "middleman" between savers and borrowers to earn a specified interest rate, the investment fund acts as the channel linking investors and countries/companies to earn an investment return. By raising funds from investors and then lending this money to countries/companies, shadow banking entities act like banks.

Advantages and disadvantages of shadow banking

Shadow banking has the benefit of reducing the dependence on the traditional banks as a source of credit. This is advantageous for the economy since it diversifies the financial system and serves as an extra source of lending. On the other hand, there is a chance that excessive lending in the economy could be a result of shadow banking.

Bad Bank

A bad bank is a financial entity set up to buy Non-Performing Assets (NPAs), or Bad Loans, from banks. The purpose of establishing a bad bank is to reduce the burden on banks by removing bad loans from their balance sheets and enable them to lend to the clients again without restrictions. After the purchase of a bad loan from a bank, the bad bank may later try to restructure and sell the NPA to investors who might be interested in purchasing it. A bad bank makes a profit in its operations if it manages to sell the loan at a price higher than what it paid to acquire the loan from a commercial bank. The main goal of a bad bank is typically not to make money; rather, it is to relieve banks from the burden of holding Non-Performing Assets and encourage them to lend more actively.

Suggested Readings

Kevin Dowd : Laissez faire banking

Suggested Questions

1. What do you understand by Laissez- faire Banking? How has Kevin Dowd visualized the evolution of a free banking system?

2. Short answer questions:
   i) Define Option Clause
   ii) Discuss briefly the development of a liquidity market under free banking system.