Meaning of money and its value in the Economy;

Monetary Theory is a study of determinants of the relationship between the quantity of money and the public economic welfare. The theory rests on the conception of economic welfare, which can be expressed in terms of objective of economic magnitudes. It traces out the way in which the quantity of the money affects these magnitudes with attention both of the end result until the process by which the result comes about.

It is proved that the economic welfare of the society depends largely on the quantity, distribution and the rate of growth of production of desired goods and services and stability of employment and prices. The productive potential of an economic system depends on the effectiveness with which they are used through technology and urbanization. Money as an institution plays a vital role in facilitating the organization of production and distribution through the price system.

In the short-run, however, production, employment and prices depend on the rate of money expenditure for goods and services. In a capitalistic economy, where economic activities are diverted for search for profits and high income, entrepreneur's decisions about production are strongly influences by current and perspective demand for their products. If, the total expenditure for goods and services are high, the entrepreneur will put to use the productive resources available in the country. If the expenditure is too high, price inflation may cause social tension and disrupt distribution and even production. If expenditure is too low, firms will not employ all the productive resources made available. The People unable to find jobs, even while output falls, fall short of meeting consumers demand. Thus, the volume of spending for current output is the central concept for monetary theory. We have to deal with the consequences of variations in G.N.P expenditure, their effects on output employment and prices and the significance of these for economic welfare.

Then, we have to turn to the problem of explaining variations in G.N.P expenditure with particular attention to the supply of money and peoples desire to hoard it or to spend it.

The classical economist, however, were of the opinion that money act's merely as a medium of exchange and does not affect output and employment. . The classical writer's considered money as a sterile or barren commodity. It was only a sort of lubricant for the process of production and distribution. It did not in any way influences the functioning of the economy. Thus, for a long time, attention was concentrated on well known technical functions medium of exchange,

standard value, the standard of differed payment and store of value. These were regarded as only essential function of money. The classical economist considered monetary disturbances in the economy only temporary and rare. And whenever they took place, they were automatically corrected. This attitude of classical economist can be attributed to the fact that they believed that the money always helps the smooth functioning of economy and does not have as independent influence of its own. It may be because their analysis always resulted to long term phenomenon and that is why they argued that since in the long run the supply of money always adjusts itself to its demand no monetary problem arises in the long period. But, today the present situation is characterized by the fact that the use of money has been so much that are cannot think of undertaking any activity neither of consumption nor production nor of exchange without its use. The system has undergone tremendous change with the change in the form of industrial line. Recent literature tends to represent money as something much more than a mere passive technical device to facilitate the exchange of goods and services and to serve as an instrument of valuation, to provide means for expressing claims and for accumulating wealth and to act as a medium through which the price system operates. The most important characteristics of modern economic life is an unending flow of money payments which are circular in nature. Households obtain money income by selling services (personnel or properly to business) and uses their money income to buy consumer goods from business. Business firms spend money to employ labour and resources in order to produce goods and services for sale at a profit. It may be possible that there may be leakages in process of this circulation. During the period of the first world war, enormous increase in the money supply was responsible for hyper inflation of many economies, especially the German economy.

The great depression was caused mainly because of the disruption of the circular flow. Thus, in an exchange economy, two unending flows run in opposite direction. One flow is the stream of goods and services which are produced and distributed by the people. The other stream is that of money payments which starts when people are paying for their productive effort and would pay others for their work. When these flows are in balanced, the price level can be considered stable and growth of the economy would be considered desirable. But, any of these flows increases without a corresponding increase in the other flow. Then, there would be either an inflation or deflation.

So, it is necessary that these two flows are kept in balance in such a way that the money supply is just adequate for the production and distribution of goods and services, required by the economy at a

particular point of time. Depressions arising out of deflation in the economy leads to mass unemployment, low level of income, under utilization of commonly used resources. Through an injection of money, in such a state of affairs, the economy can brought to life since additional purchasing power would create demand for idle resources in the economy, which would generates accumulation of upward trend, leading to the rise in the level of employment and income. That to maintain a balance in these two flows is not an easy task. The production of goods and services and the stream of their supply can never be stable in a growing economy. If the economy is to be kept at the stable level, it is necessary that the flow of money payments must adjust to the changes which takes place in the flow of goods and services over a time which means that the money supply a flexible or elastic.

The flow of money payment depends on two factors:

1. The supply of money
2. The rate of spending

Thus, merely changing the money supply will not solve the problem. But, it is also necessary that the rate of spending is also kept under control. Nowadays, almost all governments have realized the implication of over spending or under spending, over supply or under supply of money. By taking steps to increase the volume of purchasing power in the hands of consumers or by making consumers credit more rapidly available, the government may hope to stimulate and with the help of other measures, they prevent a fall in prices and it checked economic activity. The reverse policy may be adopted if it is thought that the level of consumers demand is too high, on the economic resources of the country to satisfy. It is through its influences of prices that money carries out its active functions.

Money has an important role to play even in a socialistic or collectivistic economy. For instance, in USSR, production and distribution are being control by state. But, income transactions are being carried on with the help of money. Money wage rates are serving as an important guide to occupational choices. The primary function is means of payment and standard of value. The price system is under the control of central planning authority and does not govern the production of goods. In fact, money serves as an efficient guide to economic activity and adds efficiency to the functioning of economy. In the sense, it is possible to compare the usefulness of the available resources in different fields of employment.

For under developed or less developed economies which have to achieve a rapid rate of growth and the provision of adequate monetary

resources will be necessary. Governments of these countries should collect monetary resources from all possible sources. That is, by increasing taxes, borrowing from public or even by deficit finance. The price level will change due to fluctuations in the volume of money in circulation and these changes in price level bring about economic effects which are of immense importance to the society. Thus, by controlling volume of money in circulation, the desired changes, economic as well as social can be brought about. For instance, as the economy expands in these countries, agriculture gets visualised and urban influence penetrates in to the rural sector and as a result money is increasingly used in day to day transaction. In rural areas, where money was used primarily as a store of value to fulfill the desire for high liquidity of the people and was kept in the form of silver and gold, it now assumes a more active and dynamic role by performing the other functions of money. However, we should not forget the evils to which the money has given rise. "Money is a good servant but a bad master". It is true so far in the society can be spread of this evil, if money goes out of the control of the monetary authorities, it may cause chaotic condition, it dangerous in a capitalistic economy, Great and still greater in developing and mixed economy.

One of the great defects of money is that its value or purchasing power does not remain stable. If there is inflation money gives rise to speculative activities and attracts resources away from productive channel. On the other hand, if there is deflation, the whole economic machine goes out of gear and spread misery all-round. Thus, money, which is a source of so many advantages to mankind, becomes also a source peril and confusion, unless we control it.

Value of money

The value of money is the same as the value of any other commodity. But, the most important characteristic of money, which distinguishes it from other commodities, is that it never demanded for its own sake. That is because it has the capacity to command goods of services in the market. Since, the value of money is seen only through value of other thing, it becomes necessary to reverse the normal way of estimating the value of a thing. Generally, an accurate idea of the value of money can be obtained by taking assessments of goods and services and by averaging consumption over composite commodity. In this connection, Irwing Fisher says "that the purchasing power of money is the reciprocal of the level of prices so that the study of the purchasing power of money is identical with the study of prices". Thus, the concept of value is inseparable from that of prices, if the price of the commodity

goes up it will mean that the value of money in terms of that commodity has gone down. If the value of a particular set of goods in terms of money falls, it will imply that the value of money in terms of other good has gone up.
For explaining the determination of value of money there are three theories:

1. The commodity theory;
2. The quantity theory; and
3. The income theory.

Commodity theory: According to the commodity theory of money the value of money depends upon the value of commodity or material of which it is made. This theory is largely true in earlier times when money consisted of metallic coin. The value of money unit cannot be different from its metallic contents only. If, the monetary authority reduces it freely fro fixed quantity, of metal like silver or gold of given fineness would say the value of money equaled to the value of its metal content does not indicate why precious metal of which money is made has value. According to commodity theory, the value is governed or determined by real value of metal of which it is made. There is no doubt that there is a great demand for gold for no monetary purposes. But, this demand is still less than the demand for monetary reserves. Since, gold is easy to store. Gold is demanded in large quantities, in those countries where there is a hardly used for non-monetary purposes or for ornamentation.

As a matter of fact, the value of gold itself, like, any other commodity is determined by its demand which is derived from two sources; The use of gold for monetary purpose and gold require for arts and industry.

In a modified version of this theory, money is taken as only one of many economic things. Its value therefore, is primarily determined by exactly the same two factors as determined the value of any other things. That is, the condition of demand for it and the quantity of its available. Thus the value of money is determined by the relation between the general price level and the cost of producing a metal.

Cash balance Approach to value of money:

Introduction: A straightly, different version of quantity theory of money was adopted by the Cambridge economist especially Marshall, Robertson, Pigou and J.M.Keynes. This is cash balance approach. In this approach, the demand for and supply of money have been considered in reference to the particular point of time rather than the

particular period of time. This new version of quantity theory emphasized demand side instead of supply side alone. The demand for money arises not because people want to exchange it to commodities and services, because they want to hoard it on account of various motives.

All these economists' tries to show that determination of the value of money could be a part of the general theory of value and the value of money could be determined by the forces of demand and supply.

Statement of the theory:

"In this cash balanced version, the new quantity theory assumed that for their convenience, individual wish to hoard (money) a certain proportion of real value of their planned transaction in the form of real money balance'.

(Don Patinkin)

Correspondingly, the demand for nominal money balances is KPT where P is the price level of commodity transacted. The equality of this demand to the supply of money (M), then produce the famous Cambridge equation $M = KPT$. The demand for money in the cash balance approach has reference to the store of value function of money. This type of demand for money arises from the fact that hoarding of money has great utility as it acquires "wealth value".

Hoarding of money involves a sacrifice because when it is held, people spend less. Hoarding of too little money may be inconvenience. Again, having too much money is also unnecessary. Instead of unnecessary spending, every family and every community decides the amount of money it will keep. If people want to have more cash with them it means curtailment of expenditure on goods and services. In turn, the less demand and hence, a fall in their prices. On the other hand, if they want to have less cash balances, they will spend more and prices will be pushed up. As for as the Cambridge approach is concerned, the people's desire to hoard money is based on the fact that it is a convenient asset to have being universally acceptable in exchange for goods and services.

The more transactions, the individual has to undertake the more cash which he wants to hold.

Difference between Fisher and Cambridge version:

The cash transaction version and the cash balanced version show that they are more or less similar. Because, both the version emphasizes that the price level depends upon the quantity of money. The Cambridge did considered Money as an asset, where as the transaction approach stresses the use of money as the circulating

medium. This stress in the transaction theory is on the velocity of money (V) while in the cash balance approach or theory, the stress is on idle balances kept as a part of N.I (K). However, the Fisher equation explains the value of money over a period of time, while the Cambridge equation explains the value of money at a particular movement of time. The primary concern of the both version is the price level, for the most part, both the versions accepted the basic conclusions that the value of money varied inversely with its quantity.

Superiority of cash balance version:

The superiority of the cash balance version lies in its stress laid on subjective valuation and human motive, which are the basis of all the economic activities. This is in short; contrast is highly mechanical in nature of concept of velocity in Fisher's equation. Also, the Cambridge equation is concerned with level of income which in turn determines the level of economic development, employment and price level. As a matter of fact the price level cannot be studied without reference to changes in income and output.

More over, it is not the velocity of money matters, but the velocity of circulation of money due to changes in income that matters,

The equation $P = \frac{M}{KT}$ is a more useful device than the transaction equation.

Criticisms:

But still the Cambridge approach like Fisher's approach, assumes K and T as given, the Cambridge theory also assumes that the elasticity of demand for money is unity i.e, the increased desire for hoarding cash balance leads to pari-passu a fall in the price level to the some extent. This is true only when the stock of money and the volume of goods and services remain constant.

One can conclude that the quantity theory of money does not afford a satisfactory explanation of the determination of the value of money and the factors which cause fluctuations in it. At best, this version of the theory does include only those factors which determine the price level immediately.

Both the versions, apparently suggests that price level stability can be achieved merely by regulating the supply of money. But, it is historically proved that it is not possible under all circumstances changes in price level are determined by several factors, such as institutional

psychological, technical etc. The cause and effects relationship suggested by quantity theory is also confusing, because both the equation states that changes in price level cause fluctuations in the level of economic activity in the economy. But it is also proved that the price level is changed by changes in the economic activity by the people. According to Keynes, a change in quantity of money does not affect the price level. Infact, value of money directly, but only indirectly through other elements, like rate of interest, the level of investment, income, output and employment.

Income theory:

If income theory lies beyond the Cambridge version of quantity theory, the modern quantity theory of money is based on assets creation. The modern quantity theorists treat the demand for money in just the same way as the demand or physical asset.

Financial Markets

Features of Indian Money Markets:

Introduction: The money market is a market for short term loans, i.e less than one year. The money market is not a place but an activity, the transactions are carried out by telephone, mail etc. among people who may have never met one another. Crowther in his book "A Outline of Money" has stated: 'Money market is a collective name given to the various forms and institutions that deal with the various grades of near money". The Reserve bank of India define money market as "The Centre for dealings, mainly short term character in monetary assets: it meets the short term requirements of borrowers and provides liquidity or cash to the lenders".

The money market in a nut shell is a short term credit market. It is the reservoir of short term funds. It deals in assets of relative liquidity such as treasury bills, commercial bills, short term government securities, deposits certificates, etc.

The structure of money market can be analyzed as follows:

Money Market

Components | Institutions | Instruments

Sub Markets

Call money Market | Collateral Loan Market | Acceptance Market | Bill Market

Features of Indian Money Market:

Introduction: The Indian Money Market constitutes the Reserve Bank of Indian, Commercial banks – Public Sector, Private banks and Foreign Banks, Non-banking financial intermediaries like IFCI, IDBI, ICICI, IRBI, LIC, UTI, discount and finance house of India, Brokers, provident funds, public sector undertakings and corporate units.

1. Existence of unorganized money market.
2. Lack of integration.
3. Disparity in interest rates.
4. Seasonal diversity money market.
5. Lack of proper bill market.
6. Lack of very well organized banking system.
7. Dominance of public sector banks, etc.

The Indian Economy is known for its dualism. Even in money market there are both organized and unorganized markets. These unorganized money market constitute the traditional money market in India. They are called indigenous bankers. They follow traditional methods in their business. They deal in hundis – the traditional form of bill of exchange.

Another important characteristics of money market in India is the lack of integration of different segments. However, with the passing of banking companies' regulation act of 1949 the position has changed considerably. The RBI is fully effective under various provisions of RBI act and banking companies' regulation act.
There have been too many interest rates prevailing in Indian money market. The lending rates of commercial banks, the rates of co-operative banks, the rates of RRB 's, and other financial Institutions differ with one another. This is mainly because of lack of free mobility of funds from one segment to the other. The change in the bank rate is unable to effect a uniform change in all these rates.

A notable characteristic is seasonal diversity. The rate of interest fluctuates from one period to another in the year. November to June is the very busy period. Accordingly, the rate of interest would be higher.

The bill market or the security market in India are not well enlarged in India. A well-organized bill market is essential to establish an effective link between credit agencies and RBI.

There is public sector dominance in Indian money market. More than 80% of transaction – deposit mobilization and lending – is done by public sector banks including SBI and its associates and Nationalized banks. The SBI and its group including their branches does constitute one of largest commercial banking network in the World.

The Reserve Bank of India thus fail to bring about effective implementation of its monetary policy due to the above reasons. The existence of unorganized money market, non-monetized sector, lack of banking habits among the people, wide use of direct cash, lesser use of near money assets, are some of the important defects of Indian Money Market.

Commercial Banking

Money plays a dominant role in today's life. Forms of money evolved from coins to paper notes to credit cards. Commercial transactions are increased from simple barter to speculative International trading. Hence the need arose for a third party who will assist smooth handling of transactions. Mediate between The seller and buyer, hold custody of money and goods, remit funds and also to collect proceeds. He was the 'Banker'. As the number of such mediator's grew, the need to control and regulate their activities invited governmental control. Such mediating agencies gave birth to the concept of 'Central Banks'. The banking history is Interesting and reflecting evolution in trade and commerce. It also throws light on living styles, political and cultural aspects of civilized man kind.

Banks are today forms an integral part of our everyday life. (At home; at school; at office; at business; on travel … everywhere we encounter some aspect of banking). The significance of banking in our day to day life is being felt increasingly.

Meaning and definitions of a Modern Commercial Bank

On account of multifarious functions of modern commercial banks, it is very difficult to define exactly bank or banking. Just like money one can define a bank based on its functions. Accordingly, Dr. Hart defines the banker as one "who in the ordinary course of his business honors cheques drawn upon him by persons from for whom he receives money on current accounts".

.Crowther defines a bank as "a dealer in debt and credit of its own and others".

The Indian Banking Regulation Act of 1949, defines a bank as " any firm or institution accepting for the purpose of lending or investment, of the deposits of money from the public, repayable on demand or withdraw able by cheque, draft, order or otherwise".

The banks are the financial intermediaries. There are other non banking financial intermediaries too. The deposit side functioning distinguishes them from non banking financial intermediaries

Functions;

The modern commercial banks perform varied functions. They can be classified as primary and secondary functions.

Primary functions;

1. Accepting deposits; the very base of the commercial banking depends on the extent of the deposits they collect. They do collect various kinds of deposits. They are;

Current or demand deposits, savings deposit, fixed deposit and cumulative deposits;

2. Lending loans and advances; they give security loans, advance, cash credits, overdrafts etc.

3. Discounting bills of exchange.

Secondary Functions;

1. Agential functions. On behalf its customers they perform various functions; namely, collections, remittance etc.

2. Safe deposit locker Facilities:

The bank also provides safe deposit locker facilities for the safe custody of ornaments, reliable Documents etc there by; the risk of theft is avoided.

3. Letters of credit:

In order to help the travelers the bank issue Letters of credit or travelers cheques.

4. References:

They give references about the financial position of their customers. When required they supply this information confidentiality.

5. Creation of new money or creation of credit;

6. Investments: The banks invest their money on government security, company shares and bonds and in other fields.

7. In economic development: In a planned economy like India the commercial banks have to assist Government In implementing Developmental programs.

Conclusion:

Thus it is clear that modern commercial banks are performing varied and numerous functions. They are going to lubricate the wheel of modern production and business.

Credit Creation

The process of multiple expansion of credit

Introduction: professor R.S.Sayers observes "banks are not merely traders in money but also in an important sense are manufacturers of money". The significance of this remark can be understood from the analysis of credit creation. Again, the credit creation can be explained with the origin of bank deposits.

Money, as a medium of exchange includes in its wider sense not only currency notes but also bank deposits, which are transacted from one individual to another by way of 'cheque'. The volume of bank deposits, the rate at which they are created and the rate at which they circulate have an important effect on the level of prices, economic activities, employment and income in the economy.

Bank deposits originate in two ways:

1. primary deposits or passively created deposits.

When the people deposit their money either in cash or cheques in their accounts at the banks leads to the creation of primary deposits. In this case banks merely play a passive role.

2. Actively created deposits or derivative deposits:

The process of lending creates additional deposits. Even in discounting bills of exchange or pur- chasing securities the banks can create derivative deposits. They are called derivative deposits just because of the fact that they are derived out of the banks activity that is lending or discounting bills off exchange. They are also called active deposit because banks play an active role in creation of such a deposit. This can be called creation of new money in the economy.

The banking system as a whole can bring about multiple credit creation. This process of multiple credit creation can be explained with the notion of the cash reserve ratio. (CRR).It is the amount of ready cash which the bank held when expressed as a percentage of the total deposits.

Suppose the bank feels secure in keeping a cash reserve ratio of ten percent, it means that out of every Rs 100 it receives as deposits. It should keep as ready cash of Rs 100. It can lend out the balance of Rs 90. This is called excess reserve.

Thus the cash reserve ratio points out the possibility that with an amount of cash the bank is in a position to create a total volume of deposits which is the multiple of that amount of cash.

When the bank receives an amount of Rs 100 as deposits, they can create a total amount of derivative deposits equal to Rs 1000 provided cash reserve ratio is ten percent. This is not possible for an individual bank since the derivative deposits meant to with draw by the

borrower. When he does, the bank will lose its cash. But the banking system as a whole can create an amount of derivative deposit which is a multiple of original excess reserves which the banking system has. This phenomenon of multiple credit creation by the banking system is called the process of multiple expansion of credit.

The process of multiple expansion of credit can be explained with an example. Suppose bank 'A' has original excess reserves of Rs 100, as a result of its earlier transactions. From this, it can create derivative deposit of Rs 100 in favor of a borrower. When the borrower with draw amount by cheque and pays it to an individual who has a deposit account in another bank, say bank 'B'. This amount of Rs 100 derivate deposit will be transferred to bank 'B', Where It will appear as primary deposit. Assuming uniform cash reserve ratio of 10, it will now have an excess reserve of Rs 90. It will be lent out in the form of derivative deposits. Due to the cheque payment of the borrower this amount of Rs 90 will be transferred to some other bank, say bank 'C'. From this Rs 90 bank will have an excess reserve of Rs 81? It can be lend out as derivative deposit and again it will be transferred to some other bank. This process continues till excess reserves can become negligible. The process ultimately results in the creation of an amount of derivative deposits equal to Rs 1000. It is a multiple of original excess reserves. This process can be summed up in the following table.

Uniform Cash reserve Ratio 10%

Bank 'A'		Bank 'B'		Bank 'C'	Bank 'n'
Original Excess reserves	100	Primary deposits-100		P.D-90	P.D-n
D.D	100	excess reserves	90	C.R.R-9	C.R.R-n

Sum of derivative Deposits Rs 100+ 90 +81….n=Rs 1000 in which is ten times original excess reserve. The letter 'n' Indicates the lost bank representing the final stage of credit multiplication, Where excess reserve is nil or negligible.

It must be noted that the size of the credit multiplier depends upon the size of the cash reserve ratio. The credit Multiplier is the ratio between the ultimate amount off derivative deposits created and original excess reserve.

$$Credit\ Multiplier = \frac{Total\ Volume\ of\ Derivative}{Original\ excess\ reserve} \qquad C.M = \frac{1000}{100} = 10$$

If the cash reserve ratios is low then multiplier will be high and If C.R.R is high the credit multiplier will be low. Hence the credit multiplier is the reciprocal off C.R.R.

Limitations in credit creation:

Although the banks as a whole can cause multiple expansion of credit, there are certain limitations on their power. They are:

1. Total amount of cash in the country:

The power of the bank's to create Credit depends on the Total amount of cash available in the country. Unless the large amount of cash is available for reserve, it would not be possible for them to create more money.

2. Cash reserve (C.R.R):

The credit creation by banks also depends on the cash reserve ratios. If the banks or to keep a larger cash reserve at hands, the amount of credit created should be smaller.

3. The central bank's policy relating to credit control:

The central bank can also come in the way of credit creation that means it can control or regulate the power off banks in credit creation. The credit policy of the bank has got main objectives, that is either to increase or to decrease the credit creation, For that it uses bank rate policy, open market operations, variable reserve ratio, And other qualitative methods.

4. Business conditions:

During depression, banks would not be able to create credit on a large scale. There is shortage or dearth of adequate number of borrowers.

5. Availability of assets:

The lending of banks depends upon the furnishing of proper securities by the borrowers; the lack of collateral Securities can restrict the lending activities. As Crowther Observes "The banks does not create money out of thin air; transmute other forms of wealth into money".

6. Leakages In the process of credit creation:

Some individuals who have received cheques do not deposit the proceeds or hoarding. In such cases a portion of Deposits will go out of the banking system. To that extent Credit creation will be reduced.

Conclusion: Samuelson Remarks, There is nothing automatic about deposit creation. It depends on various factors like the banking habits of the people, the state of business, Economic conditions of the country; Cash reserve ratio availability of securities and others.

<u>The Balance sheet of a Commercial Bank</u>:

The 'Balance sheet' is an annual financial statement which includes liabilities and assets. The liabilities of the commercial bank must equal its assets. That is why the name, the balance sheet (It always balances).

There are two sides in the balance sheet of the commercial bank. On the left hand side comes liabilities and on the right hand side assets.

The 'liabilities' means how much a commercial bank owes to others. It is the debt of commercial bank to others. Where as 'assets' represents the bank's claim on others. It represents how much others owe to the bank. It is the debt of others to the bank.

An imaginary balance sheet of a commercial bank is shown in the following table:

Liabilities	Assets
1. Capital liabilities	1. Cash with itself, with other Commercial banks and Central bank
a. Authorized Capital	2. Money at all and short notice
b. Issued capital	3. Bills Discounted
c. Subscribed capital	4. Investments (Shares, debentures, and bonds)
d. Called up And Paid up capital	5. Loans and advances
2. Reserve funds	6. Acceptance and endorsement
3. Deposit liabilities	7. Buildings, furniture etc, and others
a. Primary deposits	
b. Derivative Deposits	
4. Acceptance and endorsement and Others	

Management of liabilities and assets:

Liabilities: There are two major parts of liability side there are

1. Capital liabilities
2. Deposit liabilities

1. Capital liabilities: The capital liabilities represent to the liabilities of a commercial bank to its shareholders. The capital liabilities can be distinguished as authorized capital, issued capital, subscribed capital and called up and paid up capital. The paid up capital represents the actual capital liabilities.

Reserve funds: These represent the accumulated profits which are kept as reserves. Normally a bank will take out some percentage of profits earned every year and maintained as a reserve, this also represents liabilities.

2. Deposit liabilities: The second important liability of a commercial bank is the liabilities to its depositors, there are two kinds of deposits. They are

Primary deposits

Derivative Deposits

The Derivative deposits represent the liability of a commercial bank to its borrowers.

The capital liability does not create the burden of immediate payments but the bank has to pay the dividends to the shareholders. They represent long term liabilities; out of deposits current and savings represents immediate liabilities the depositors may come in any moment to withdraw such deposits. But the fixed deposits can be hold by commercial bank for certain period. They do not create the liability problems; hence it is convenient and profitable for a commercial bank to hold such deposits. They can be lent out to other are used for investments. Accordingly the depositors of fixed account will get higher rate of interest.

Management of assets or portfolio management or the investment policy:

The asset side of the balance sheet of a commercial bank is much more complicated than liabilities side. Rather there are more items on assets side. Again it is not so easy to manage the assets. Because the longer run sustenance of a commercial bank depends upon its efficiency in managing assets.

The investment policy or the type of Assets owned by a Commercial bank is guided by three fundamental Banking principles,

They are as follows

Liquidity

Profitability

Safety

The liquidity problem represents the day to day problem of a commercial bank to fulfill the short term objective the bank has to maintain some portion of its assets in ready cash. Has shown in the above balance sheet, cash with itself, with other commercial bank, with central bank and money at call and short notice can help the commercial bank, to meet the demand cash at the counter. These are Liquid assets. The cash is the most liquid off all assets. So also money at call and short notice these are temporarily lent out to others for very short period. These amounts can be obtained just while giving a short notice or a call.

On the other hand there are some assets which are more profitable. They are investments, loans, etc, which are more profitable. That means investing on such assets will bring more income to the bank in future. But the liquidity quality of these assets is negligible. They are called illiquid assets. They are not directly and immediately negotiable. It is not possible to convert these assets into cash.

There are some other instruments or assets like money at call, bills of exchange, and treasury bonds etc, which are convenient and profitable for a commercial bank. This is because they are having the elements of both liquidity and profitability.

Central bank

<u>Introduction</u>: The enlarging monetary systems and the failure of Commercial Banks necessitated the emergence of central bank. For international monetary and financial stability a conference was held at Brussels. It declared that it is a must that every country should have a central bank. The evolution of central banking was closely associated with the evolution of the bank of England, established in 1694.

Definitions: According to Dekock "A central bank constitutes the apex of the monetary and banking structure of the country and control banking activities in the general interest of the economy".
Hawtrey described the central bank as "The lender of last resort".
According to Kisch and Enkin "The main task of central bank is to maintain monetary stability".

<u>Functions of central bank</u>:
1. Note issue: That issue of currency notes is the monopoly power of the central bank. In fact, the history of central banking is associated with this function of Note Issue.
2. Agent, banker and adviser to the government: In almost all the countries, the central bank will act as the agent of the government. It receives payments on behalf of the government. It manages public debt for the government. As a banker, it performs that functions to the government, as Commercial bank does to its customers. Finally, being an apex body of monetary and banking system, It can advise the government on all banking and financial matters.
3. As bankers' bank: In its capacity as bankers bank, the central bank performs the following functions:
a. Custodian of Cash Reserve of commercial bank.
b. Lender of last resort.
c. Bank of central clearance and Transfers.

4. Controller of credit: In the interest of the economy, it has to control the lending activities of commercial bank. The credit control means expansion and contraction of money supply in the general interest of the economy (To avoid inflation and deflation).
5. Custodian of foreign Exchange reserves: The central bank has to maintain with itself the reserve of all the currencies accrued to the country in the process of foreign trade. It has to maintain the official rate of exchange and fixes the rate of exchange. Then it has to maintain the stability of external value of the home currency.

6. Promotional functions: The central banks in the developing countries like India have to perform certain developmental function In addition to the above Central banking functions. They are Promotion of Credit to agriculture, Industry etc, Promotion of banking Habits and thrifts among the rural People giving encouragement to start branches in rural and backward regions Implementation of so many Developmental programs, propaganda, etc.

Credit control by the Central Bank:

The credit control policy of the central bank is also called the monetary policy. The monetary policy is aimed at the management of proper level of money supply. It involves the process of both expansion and contraction. So to achieve this purpose, the methods of credit control are as follows:

1. Quantitative methods or general methods,
a. Bank rate policy
b. Open market policy
c. Variable reserve ratio
2. Selective methods or qualitative methods of credit control.

Bank rate policy:

The bank rate or discount rate is a minimum rate at which the central bank is going to discount or rediscount the bills of exchange brought to it by the commercial bank. It is also called the cost at which the central bank provides financial accommodation to the commercial banks.

The bank rate was the traditional means of credit control. This bank rate policy was for the first time evolved and used effectively by the bank of England. The mechanism of bank rate policy is that when bank rate increases, the other lending Rates in the money market will also increase, then ran increase in the lending rate reduces the borrowings and brings about contraction in money supply. Whenever Bank rate decreases, the lending rates will also decrease in the money market. Consequently the borrowings and money supply can be increased. During the inflation, the central bank will rise the bank rate to discourage the borrowings (dearer money policy). In the opposite Case When there is deflation or depression if reduces the bank rate or follow cheaper money policy.

Preconditions of bank rate policy: the successful operation of the bank rate policy depends on the following pre-conditions;

1. There is a direct relationship between bank rate and other lending rates in the money market.
2. The commercial banks should depend upon for central bank for extra lending (They have maintained Minimum reserves).
3. Borrowings depend upon the lending rates.
4. The commercial banks are not prejudice against rediscounting at the central bank.
5. Existence of organized money market
6. They posses' eligible securities,
7. Prices, wages, employment's and production are all flexible so that, they can expand or contract according to the changes, in borrowing and investment.

Limitations: The bank rate as an instrument of credit control commanded great respect till the great depress of 1930's. The popularity of bank rate found in the Macmillan committee report that "The bank rate policy is an absolute necessary for the sound management of the monetary system and that it is the most delicate and beautiful instrument for the purpose". In spite of that the effectiveness of bank rate policy depends upon the existence of the above mentioned preconditions. Due to the changes in the structure of the economies of the various countries bank rate lost much of its effectiveness. Consequently the need for other measures was keenly felt. It is only an inducing method. One cannot see a direct relationship between bank rate and all other rates in the money market. More importantly, the investors are finding other methods to raise funds like shares and debentures, mutual funds etc. then interest rate alone cannot influences investment, etc.

Variable cash Reserve Ratio

The commercial banks are required to keep a part of their cash reserves with the central bank as a method of promoting the overall liquidity and solvency of the banking system. These cash requirements of Commercial banks are supposed to provide the central bank's with an additional method of credit control. This method was introduced in the United States In 1933, and was made a permanent feature of the credit control activities of the Federal Reserve System in 1935. This method was soon adopted by other countries such as Belgium, Sweden, West Germany, India and many others.

The theory behind variable cash reserves is that by altering the cash reserve ratio, which the commercial banks are required to maintain with the central banks, the credit base of the commercial banks be directly altered; thereby, affecting their ability to create credit. When the

commercial banks indulge In an harmful expansion of credit on the basis of their excess cash reserves, the Central Bank raises the cash reserve ratio and thereby sterilizes a part of the cash reserves of commercial banks Which are There by forced to contract the volume of credit created by them. Inflationary expansion of credit is thereby being controlled. on the other hand, when there is deflationary situation In the economy and the central bank wants to bring about a revival of prices, it lowers the cash reserve ratio so has to expand the credit base of commercial banks which induces Them to expand their credit activities. Expanding volume of credit encourage economic activity and the level of prices to rise.

Selective methods of Credit control:

The greatest drawback of the different methods of general credit control is that they are not discriminate in their effects. In controlling the total volume of credit in the economy, they restrict not only unproductive activities but also prevent the investment activities. What is actually required during a period of inflation is not the mere control of the quantity of credit, but a control of the quality or use of credit.

1. The main objective of qualitative credit control measures is to curtail the volume of credit flowing into a unproductive uses and thereby diverting credit into productive lines.
2. To control the overall volume of credit by controlling unproductive and less urgent uses of credit.
3. To bring under the control of the central bank credit created by private non banking credit institutions also, and
4. To have a method by which it is possible to control certain fields of credit without touching other fields of credit activities.

Forms of Selective Credit control

1. Prescribing margin requirements on secured loans:

The method of prescribing margin requirements for secured loans granted by banks, brokers and dealers was made use of for the first time in U.S.A. under securities exchange act of 1934. This act empowered F.R.S “To prescribe the rules and regulations with respect to the amount of credit that can be extended by banks against securities”. The theory behind this method is very simple. By prescribing margin requirements on these loans, the banks are not allowed to lend the full value of the securities. But can lend only a part of their market value. At the margin requirement of 40 percent, the banks lend only 60 percent of the value of the securities, this implies that a person who intends to purchase a

security can borrow only a part of its value from the banks, and has to find out himself another part of the value of the security equal to the margin prescribed. Hence, by altering the margin requirement that amount of loan made available by the banks can be altered.

2. Consumer credit regulation: Another method of selective credit control is that of regulating the volume of consumer credit, repayable in installments, for the purchase of durable consumer goods. Bank advances on easy terms for the purchase of these goods will lead to a large increase in the demand for durable luxury goods. Hence, In the interest of economic stability it is necessary to control and regulate consumer demand for durable luxury goods arising out of installments credit or advances made by banks.

3. Rationing of credit: Rationing of credit as an instrument of credit control was used by the bank of England towards the end of the eighteenth century. Rationing of credit implies that the central bank places a limit upon its rediscount facilities for anyone discount house. Credit rationing may also take the form of a ceiling for the rediscount facilities which the central bank offers to the discount houses and bank.

4. Control of bank advances: Another method of exercising control over the activities of Commercial banks is that of controlling bank advances. A discretionary control over the lending policies of commercial banks, so that bank credit is diverted from less urgent to more urgent uses. The central bank directs the banks not to lend for certain purposes, fixes maximum limits up to which banks can lend for certain purposes etc, by this method resources are diverted from and productive speculative fields to productive fields off activity.

5. Moral suasion: It takes the form of advice and direction by the central bank to the commercial banks not to follow unsound lending policies. Unlike direct actions, moral suasion does not lead to any psychological reaction on the part of the commercial banks, since It is “Not accompanied by statutory or administrative compulsion or threats of punitive action”. The success of moral suasion depends entirely on the moral influence of the central bank over the commercial banks. The success of moral suasion as a method of credit control is however depends upon the monetary leadership of the central bank. It is found to be successful in such as England, France, Sweden and Holland. Commercial banks willingly and traditionally accept that advice and monitor the leadership of the central bank.

6. Direct action; it implies that a central bank may take cohesive measures against banks following unsound credit policies. It may issues special directions in general to any particular bank regarding their activities. These methods required to meet the statutory obligations.

7. propaganda or publicity; money central banks have adopted publicity as an instrument of policy so as to influence, educate and shape the credit policies of banks and other monetary institutions and public opinion in the country. So, it makes their monetary policies more effective. Publicity takes the form of the central banks “publishing regularly weakly statements of their assets and liabilities, monthly reviews of credit and business conditions, and comprehensive annual reports on their own operations and activities, money market and banking conditions generally, public finances, trade industry, agriculture etc,” Dekock.

Limitations of selective credit control:
Selective credit controls imply the diversion of bank funds from less urgent and unproductive uses to more urgent and productive fields. In practice it is very difficult to distinguish between less urgent and more urgent uses, so that the selective methods of credit control cannot be effectively applied.
The second limitation is that the banks do not have control over the ultimate use of credit. Banks can control only immediate use of credit.

Conclusion: In conclusion it should be noted that the two broad groups of credit control measures quantitative and qualitative are no competitive and exclusive methods. The success of monetary policy depends not in choosing either of the two exclusively of the other, but in combining the two appropriate proportions depending upon the prevailing credit conditions of the economy. A judicious and harmonious combination of the two groups, and the different components there of, is necessary in order to make the monetary policy of the central bank successful is realizing the different objectives.

Monetary Policy

Monetary policy plays an important role in the promotion of economic development and maintenance of economic stability in all countries of the world.

Since money plays a dynamic role in influencing economic activities, this policy has assumed greater importance in a modern economy. Today the role of monetary policy has been recognized by the Economist's in achieving price stability and full employment.

Monetary policy is basically concerned with monetary system of the country. It refers to the policy adopted by the central bank of the country with regard to monetary matters.

In other words it refers to the policy followed by the central bank to control in volume of currency, Credit and interest rate with a view to achieve certain economic objectives. This policy includes all measures and steps under taking by the central bank in order to regulate the supply of money and interest rates.

The term monetary policy has been defined differently by different Economist's. Some of the important definitions of monetary policy are as follows:

According to Harry.G.Jhonson "Monetary policy refers to a regulatory policy where by the central bank maintains its control over the supply of money for the realization of general economic goals"

According to Professor Wrightsman defines monetary policy has the deliberate effort by the central bank to control the money supply and credit for the purpose of achieving certain broad economic objectives.

From the above definitions it is clear that monetary policy is the policy of the central bank to control the supply of money, credit and interest rate with a view to achieve several national objectives such as economic development, price stability, full employment etc,. In all countries of the world central bank is interested with the responsibilities of formulating and implementing monetary policy.

It is needless to say that monetary policy of India is carried out by the Reserve Bank of India, which is our central Bank.

Monetary Policy in Economic Development
Or
Role of Monetary Policy in developing countries
Or
Objectives of Monetary Policy:

Monetary policy in developing country should play an active role in the process of economic development. This policy should create an atmosphere in which the national Economy can achieve rapid economic development. The role of Monetary policy in economic development can be understood with the help of following points, namely:

1. Creation and establishment (or) expansion of Financial institutions:

An important objective of monetary policy in developing countries is to speed-up the process of economic development by creating and expending the financial institutions.

These financial institutions play a very important role in the economic development of any nation. They mobilize savings of the people and provide funds to the development of various economic activities. But unfortunately financial institutions are inadequate in under developed countries.

Therefore, the central bank through its monetary policy should create and expand financial institutions so has to provide credit facilities and mobilize savings for productive investment. Further central bank should see that adequate funds are available to all productive activities in order to achieve rapid economic development.

2. Promotion of capital formation:

Another objective of monetary policy in developing countries is the promotion of capital formation for economic development. The rate of capital formation is very low in developing countries due to low level of savings and investment. Therefore, monetary policy in developing countries has to mobilize large amount of savings in order to promote investment of the production of capital goods. This contributes to increase in the rate of capital formation and results in higher rate of economic growth.

3. Price Stability: It is an important objective of monetary policy in all developing countries of the world. Price stability refers to prevention of wide fluctuations in price. Rising or falling prices are both bad to the economy because they bring unnecessary loss to some people and undue advantages to others. Therefore, central bank with the help of its

monetary policy can achieve price stability by regulating the supply of money and credit in the economy.

4. Solving adverse or deficit balance of payments problems: Monetary policy of developing countries should adopt measures to solving balance of payment difficulties. Generally all under developed economies are suffering from adverse balance of payments. This is due to excessive imports over exports. The central bank with the help of its monetary policy can solve this problem by making more funds available to export industries for the expansion of exports.

5. Achieving full employment: Another most important objective of monetary policy in developing countries in achieve full employment. Since the publication of Keynesian of "General Theory", most of the economist's considered full employment as an ideal objective of monetary policy. The use of monetary policy to achieve full employment was mainly advocated by J.M.Keynes in England (general theory of employment, interest and money) a famous book in the year 1936.

In the opinion of Keynes deficiency of investment is the main cause for unemployment in under developed countries. He pointed out that an economy can achieve increasing level of employment by promoting investment. He suggested that the central bank in a developing economy has to encourage investment by following "cheap money policy", in order to create more and more employment opportunities in the country. This policy encourages the businessmen and producers to borrow more money and invested on productive activities. An increase in investment generally leads to increase in production and employment opportunities. In this way monetary policy can help in achieving full employment in developing economies.

6. Adopting suitable interest rate policy: In an under developed economy the interest rate generally stands at higher level. This acts as an obstacle to the growth of public and private sector investment. Therefore, a low interest rate policy is very essential for encouraging investment in agriculture and industry. But a low interest policy may encourage borrowing for unproductive purposes. In order to discourage the flow of funds for unproductive activities, the central bank should follow a policy of discriminatory interest rates. i.e. charging lower rates for productive activities, and higher rates for unproductive activities.

From the above discussion it is clear that monetary policy plays a vital role in the economic development of developing countries. This policy contributes to expansion of all productive activities and brings about increase in the volume of investment and production in the country.