MONEY AND BANKING

COURSE CODE: B21EC02DE

Discipline Specific Elective Course
Undergraduate Programme in Economics

SELF LEARNING MATERIAL

SREENARAYANAGURU
OPEN UNIVERSITY

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The State University for Education, Training and Research in Blended Format, Kerala

SREENARAYANAGURU OPEN UNIVERSITY

Vision

To increase access of potential learners of all categories to higher education, research and training, and ensure equity through delivery of high quality processes and outcomes fostering inclusive educational empowerment for social advancement.

Mission

To be benchmarked as a model for conservation and dissemination of knowledge and skill on blended and virtual mode in education, training and research for normal, continuing, and adult learners.

Pathway

Access and Quality define Equity.

Money and Banking

Course Code: B21EC02DE

Semester - III

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Self Learning Material

(With Model Question Paper Sets)

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MESSAGE FROM VICE CHANCELLOR

Dear learner,

I extend my heartfelt greetings and profound enthusiasm as I warmly welcome you to Sreenarayanaguru Open University. Established in September 2020 as a state-led endeavour to promote higher education through open and distance learning modes, our institution was shaped by the guiding principle that access and quality are the cornerstones of equity. We have firmly resolved to uphold the highest standards of education, setting the benchmark and charting the course.

The courses offered by the Sreenarayanaguru Open University aim to strike a quality balance, ensuring students are equipped for both personal growth and professional excellence. The University embraces the widely acclaimed "blended format," a practical framework that harmoniously integrates Self-Learning Materials, Classroom Counseling, and Virtual modes, fostering a dynamic and enriching experience for both learners and instructors.

The university aims to offer you an engaging and thought-provoking educational journey. The undergraduate programme in Economics is designed to be on par with the high-quality academic programmes offered at state universities throughout the country. The curriculum incorporates the latest methodologies for presenting economic ideas and concepts. It stimulates students' interest in developing a deeper comprehension of the discipline. The curriculum encompasses both theoretical concepts and historical evidence. Suitable emphasis is placed on India's experiences with economic transformation. This would aid learners in preparing for competitive examinations, should they choose to take them. Upon successfully completing the programme, we anticipate that students will be well-equipped to handle key areas within the economics discipline. The Self-Learning Material has been meticulously crafted, incorporating relevant examples to facilitate better comprehension.

Rest assured, the university's student support services will be at your disposal throughout your academic journey, readily available to address any concerns or grievances you may encounter. We encourage you to reach out to us freely regarding any matter about your academic programme. It is our sincere wish that you achieve the utmost success.

Regards,
Dr. Jagathy Raj V. P.

01-01-2025

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Money

UNIT 1

Money and Monetary Standards

Learning Outcomes

After learning this unit, the learner will be able to:

- understand the concepts of money
- know about the types of money
- get an idea about the index numbers

Prerequisites

Money is a fundamental concept that serves as a medium of exchange, facilitating the buying and selling of goods and services. It is a universally accepted measure of value, a store of wealth, and a standard for deferred payments. In modern economies, money exists in various forms, including coins, paper currency, and digital assets, adapting to the changing needs of society. Without money, human life would become inefficient. People would need to revert to the barter system, which is cumbersome and limited in scope. The absence of money would lead to unequal resource distribution, with powerful individuals hoarding essential goods. This could create anxiety, insecurity, and a lack of motivation among people, destabilising social structures and economic systems. Hence money is vital for human life as it enables access to necessities like food, shelter, and healthcare. It influences economic stability by managing inflation, employment, and growth. Beyond fulfilling basic needs, money also provides opportunities for education, leisure, and personal development, thereby improving living standards and brings social progress. Over time, the forms of money have evolved, reflecting the advan-cements in human civilisation. From the barter system to commodity money (such as gold and silver), paper currency, and now digital transactions, money has adapted to meet the demands of changing economies. Each stage of

money has contributed to the efficiency and prosperity of trade, industry, and commerce. In this context, let us examine these concepts in detail.

Keywords

Money, Metallic Money, Fiat Money, Near Money, Medium of Exchange, Store of Value, Inflation, Deflation, Index Number

Discussion

1.1.1 Money

According to Francis Walker, "Money is what money does". Money is considered one of the important inventions of man. It is impossible to think about a world without money. Everyone needs money for various purposes; starting from the day-to-day transactions to savings for the future. But if you go back to our past, you will find that before the invention of money, there was a 'Barter system' for the exchange of one good or commodity for another good or commodity. With the development of the economy, the Barter system lost its ground and was replaced by money.

There are mainly three alternative definitions regarding money. The most common view is the traditional definition, which considers money primarily as a medium of exchange. According to this perspective, the money supply is defined as the currency held by the public and demand deposits held by commercial banks. The second definition is broader than the first and is associated with the name of Milton Friedman. He defines the money supply at any given point in time as consisting of the dollars people carry in their pockets, the dollars they have in their bank accounts in the form of demand deposits, as well as commercial bank time deposits. This definition includes M1 (currency and demand deposits) plus time deposits of commercial banks and its emphasis on the store of value function of money. The third and broadest definition is associated with Gurley and Shaw. According to their view, the money supply consists of demand deposits, currency held by the public, time deposits, and savings deposits held by banks.

1.1.2 Evolution of Money

The evolution of money traces the journey from barter systems to the complex financial instruments used today. Each stage represents a step towards creating more efficient, secure, and scalable methods of exchange. The evolution of money has passed

through the following five stages depending upon the progress of human civilisation. Let us explain them in detail.

1.1.2.1 Commodity Money

Commodity money refers to commodities used as money that have intrinsic value. The worth of such goods is derived from the material they are made of. This form of money was widely used in ancient periods. For example, the Romans used cattle and salt, the Mongolians used squirrel skins, the Japanese used rice, and the Chinese used tea as money. Various other commodities, such as spears, animal skins, bows and arrows, and axes, were also used as money. During this period, commodity money was used in various countries, but it had several drawbacks. Commodities were not uniform in quality, making pricing difficult, as seen with examples like cattle and grain. Additionally, the availability of these commodities was unpredictable, and they were difficult to store, often losing value over time. These commodities were also challenging to transfer from one place to another due to their lack of portability. Furthermore, they could not be divided into smaller units for transactions, limiting their practicality.

1.1.2.2 Metallic Money

The next stage in the evolution of money is metallic money, which replaced commodity money. Metallic money refers to money made from metals like gold, silver, copper, tin, or other durable and valuable materials. Due to the inconveniences associated with commodity money, such as issues of weight, divisibility, quality assessment, and storage, society accepted metallic coins. These coins had a predetermined weight, an innovation attributed to King Midas of Lydia in the 8th century BC. Coins became a more practical medium of exchange compared to commodity money.

1.1.2.3 Paper Money

Paper money refers to currency made of paper or similar materials. It is issued by a central authority, such as a government or central bank, to be used as a medium of exchange. Paper money has no intrinsic value and its worth is derived from the trust and acceptance of the issuing authority. The evolution of paper money began with goldsmiths. Goldsmiths, who stored gold in strong safes, earned the trust of people who deposited their gold with them for safekeeping. In return, the goldsmiths issued receipts promising the return of gold on demand. Over time, as trade and commerce increased, these receipts were used as substitutes for actual money. Compared to metallic money, paper money offers advantages such as easy portability and reduced weight. Hence these paper receipts became widely accepted as a form of money backed by gold, ultimately leading to the creation of banknotes.

1.1.2.4 Credit Money

Cheques emerged as a significant stage in the modern evolution of money. A cheque is a written order directing a bank to transfer a specific sum of money from the issuer's account to another person or entity. A cheque shares similarities with a banknote in

that it facilitates the transfer of money. However, unlike a banknote, a cheque is issued for a specific amount and is valid for a single transaction. Cheques have become a convenient method for handling large transactions, whereas banknotes are typically used for smaller, everyday exchanges.

1.1.2.5 Near Money

Near money refers to assets that are close substitutes for cash and are highly liquid. Liquidity is a financial term used to describe non-cash assets that can be quickly converted into cash without a significant loss in value. Examples of near money include bills of exchange, treasury bills, bonds, debentures, and savings certificates. The ownership of near-money assets can be transferred easily, often through simple book entries, making them convenient for financial transactions and short-term liquidity needs.

1.1.2.6 Electronic Money

Electronic money refers to any form of money that exists in digital or electronic form. Credit cards fall under this category because they enable transactions electronically, allowing users to access funds stored in their bank accounts without needing physical cash. Examples of electronic money include debit cards, prepaid cards, mobile payment systems such as Apple Pay, and Google Pay, and cryptocurrencies like Bitcoin. Credit cards are considered a key component of modern electronic money systems.

1.1.3 Functions of Money

Money serves as a crucial medium in the economy, facilitating trade, exchange, and the efficient allocation of resources. The major function of money is widely recognised as a medium of exchange, store of value, unit of account, and standard of deferred payment. Each of these roles contributes to the smooth functioning of economic activities and it also ensures that goods, services, and financial transactions occur effortlessly. Understanding these fundamental functions provides insight into how money supports economic growth and stability. Broadly speaking the functions of money can be classified into three:

- The primary function of money
- Secondary functions of money and
- Contingent functions of money. Let us discuss them in detail.

1.1.3.1 Primary or Basic Functions

We know that money has become more widely accepted compared to the features of the barter system due to its ease of transfer and the lack of limitations on carrying capacity. Therefore, the primary functions of money are often considered the fundamental roles that define its purpose. Let us examine these functions in detail.

1. **Medium of Exchange:** Money acts as a medium of exchange for all

goods and services. The use of money has greatly facilitated the process of exchange by dividing it into two parts i.e. sale and purchase. It removed the difficulty of double coincidence of wants, and the inconveniences and difficulties associated with the Barter system. When money acts as a medium of exchange, it means it is generally acceptable. It affords the freedom of choice. With money, we can buy a bundle of goods and services and at the same time, we can purchase the best and also bargain in the market. Thus, money gives a good deal of economic independence and also a perfect market mechanism by increasing competition and widening the market.

2. **The Measure of Value:** Money helps us to measure the value of goods and services in terms of price. This function has greatly facilitated the process of exchange of different goods and services. The value of the goods is determined by multiplying its price by the quantity purchased. Since the price is expressed in monetary units, the value of goods is also expressed in monetary terms. The use of money as a standard of value eliminates the necessity of quoting the price of apples in terms of oranges, the price of oranges in terms of nuts, and so on.

1.1.3.2 Secondary Functions

The secondary functions of money complement its primary role and enhance its utility, ensuring broader applicability in economic transactions. The major secondary functions of money are: **a standard for deferred payments, a store of value, and a means of transferring value**. Let us discuss them in detail.

1. Store of Value or Wealth

Money is the most convenient and economical means of storing wealth, as it tends to retain its value over time. Therefore, it is widely accepted as a method for storing wealth or value. As a medium of exchange, money allows you to purchase goods and services. When you hold money, you possess the purchasing power to acquire these goods. Thus, the value of goods is indirectly stored in the money you hold. Similarly, when selling goods, you receive money, which represents the value of those goods. Like money, other valuable assets, such as short-term promissory notes, bonds, mortgages, stocks, real estate, and household goods, can also serve as stores of value. These assets can generate income through interest, profits, rent, or appreciation in value. However, they may involve storage costs, can depreciate their value, and are often less liquid compared to money.

2. Standard of Deferred Payments

Money acts as a means of deferred payments. Deferred payments refer to payments promised to be made at a future date. In the case of commodity money, which may lose value over time and may not always satisfy the double coincidence of wants, that is, both parties need what the other offers, money retains its value more consistently and is widely accepted for settling debts in the future. When engaging in borrowing and lending activities, money is typically the only accepted form of payment for future obligations. As a standard of deferred payments, money plays a crucial role in capital formation for both governments and business enterprises, fostering financial and capital

markets and contributing to overall economic growth.

3. Transfer of Value

This function of money is derived from the store of value function of money. Money is used to transfer value from one place to another or from one person to another. As a traveller when you move from one place to another, you can easily carry money to make necessary transactions on the way and in your destination place. You can also transfer the money through the bank. Now people carry credit or debit cards to withdraw cash wherever the facility is available.

1.1.3.3 Contingent Functions of Money

According to Prof. David Kinley, money also performs certain contingent or incidental functions they are;

1. Money is the most liquid of all liquid assets

Money is the most liquid of all liquid assets in which wealth is held. Individuals and firms may hold wealth in varied forms. They may choose between holding wealth in a currency, demand deposits, time deposits, savings, bonds, treasury bills, short-term government securities, long-term government securities, debentures, preference shares, ordinary shares, stock of consumer goods, and protective equipment. All these are liquid forms of wealth that can be easily converted into money.

2. Basis of The Credit System

Money is the basis of the credit system. Business transactions are either in cash or on credit. Money is the back of all credit. A commercial bank cannot create credit without having sufficient money in reserve.

3. The Equaliser of Marginal Utilities and Productivities

Money acts as an equaliser of marginal utility for the consumer. The main aim of the consumer is to maximise his satisfaction by spending a given sum of money on various goods which he wants to purchase. Since prices of goods indicate their marginal utilities and are expressed in money, money helps in equalising the marginal utility of various goods. Money also helps in equalising the marginal productivity of various factors. The main aim of the producer is to maximise his profits. For this, he equalises the marginal productivity of each factor with its price. The price of each factor is nothing but the money he receives for his work.

4. Measurement of National Income

Under the Barter system, it is impossible to calculate the national income of a nation. Money helps in measuring national income. This is done by assessing the production of various goods and services in the country in monetary terms.

5. Distribution of National Income

Income is generated by the factors of production engaged in the production process. Money helps in the distribution of national income. The factors such as land, labour,

capital, and entrepreneurship get the rewards in the form of rent, wage, interest, and profit respectively. The factors of income are determined and paid in terms of money. Thus, national income is measured by using the income method.

1.1.4 Kinds of Money

Money exists in various forms, each possessing unique characteristics. Understanding these forms is essential for comprehending the diverse roles money plays in the economy. Let us examine them in detail.

1.1.4.1 Commodity Money

Commodity money is the simplest and the oldest type of money. It builds on natural resources that act as a medium of exchange, store of value, and unit of account. Commodity money is closely related to the Barter system. The critical thing to be noted about commodity money is that its value is defined by the intrinsic value of the commodity itself. In other words, the commodity itself becomes money. Examples of commodity money include gold coins, beads, shells, spices, etc.

1.1.4.2 Fiat Money

Fiat money gets its value from a government order (i.e., fiat). That means, the government declares fiat money to be legal tender, which requires all people and firms within the country to accept it as a means of payment. If they fail to do so, they may be fined or even put in prison. Unlike commodity money, fiat money is not backed by any physical commodity. By definition, its intrinsic value is significantly lower than its face value. The value of fiat money is derived from the relationship between supply and demand. Most modern economies are based on a fiat money system. Examples of fiat money include coins, currency, and bills.

1.1.4.3 Fiduciary Money

Fiduciary money refers to a currency that derives its value from the trust and confidence that it will be accepted as a medium of exchange. Unlike fiat money, which is declared legal tender by the government, fiduciary money is not mandated by law to be accepted for transactions. Instead, its acceptance relies on the issuer's promise to exchange it for a commodity or fiat money upon request. As long as people trust that this promise will be honoured, fiduciary money functions effectively in the economy. Examples of fiduciary money include cheques, banknotes, and drafts.

1.1.4.4 Standard Money

Standard money refers to a form of currency that serves as the benchmark for measuring the value of all other forms of money within a country. It is characterised by unlimited legal tender status and is subject to free coinage, meaning individuals can bring their metal to be minted into coins. Typically, the intrinsic value of standard

money equals its face value and is often composed of precious metals like gold or silver.

1.1.4.5 Token Money

Token money is made of cheaper metal, it has a limited legal tender, it is not subject to free coinage and its face value is greater than its intrinsic or metallic value. Token money consists of small coins. The rupee is the standard unit of money in India, but its face value is greater than its real value.

1.1.4.6 Bank Money

Bank money refers to bank deposits. The bank deposits can be turned into money by their depositors employing cheques. Cheques or bank money are superior to other forms of money in such a way that they are convenient for mailing, paying exact sums, providing receipts in the form of counterfoils, and on account of being safe against being stolen or misplaced.

1.1.4.7 Money of Account

Money of account is the monetary unit in terms of which the accounts of a country are kept and transactions made, i.e., in which general purchasing power, debts, and prices are expressed. The rupee is our money of account.

1.1.4.8 Metallic Money

Metallic money refers to coins made from various metals such as gold, silver, bronze, and nickel. Its value is guaranteed by the state's exclusive monopoly. Metallic money consists of coins made of gold, silver, nickel, or copper. The coins may be standard coins and token coins. Standard coins have unlimited legal tender, are subject to free coinage, and have their face value equal to their metallic or intrinsic value while token coins have limited legal tender which is not subject to free coinage, and have a face value greater than its metallic or intrinsic value. A coin has value because it is made of a valuable metal. It is full-bodied if its face value is equal to the metal contained in it. Sometimes a coin has value only because the government has stamped it. When the value given to a coin by the government is more than its contents, it is called a 'token coin'. It is only the privilege of the government to do token coins. All coins circulating in India are token coins including the rupee and paise coins.

1.1.5 Monetary Standard

A monetary standard is the system a country uses to determine the value and supply of its money. It governs how money functions as a medium of exchange, a store of value, and a unit of account within the economy. It determines how the currency is issued, its backing, and the mechanisms for its circulation and exchange. The choice of a monetary standard influences economic stability, inflation rates, and the overall functioning of financial systems. The monetary standard can be divided into two types they are:

1. Metallic Standard and

2. Paper Standard

1.1.5.1 Metallic Based System

The metallic-based system refers to a monetary standard in which the value of a currency is directly linked to a specific quantity of precious metal, such as gold or silver. Historically, gold and silver have served as money, with gold being more widely used than silver. Precious metals were chosen as money for several reasons. First, gold was in limited supply, and annual additions to the global stock of gold were relatively small, making its value stable and allowing it to serve as a good store of value. Second, gold had the characteristics of an efficient medium of exchange, such as portability, divisibility, durability, and resistance to counterfeiting. Third, gold had alternative uses beyond its monetary role, including decorative, religious, artistic, and industrial applications. Finally, gold and silver are relatively soft metals, which made them easy to work into coins even with the primitive technologies of ancient times. As a result, gold and silver acquired both monetary and non-monetary value.

Metallic standards can be classified into two types: monometallism and bimetallism. Monometallism refers to a monetary system where only one metal, either gold or silver, is used as the standard currency. Coins made from this metal serve as legal tender for transactions, and there is unlimited minting of these coins. On the other hand, Bimetallism is a system where two metals, typically gold, and silver, are used as standard money, with a fixed legal ratio established between their values to facilitate easy exchange. Both gold and silver coins are freely minted, circulated, and are convertible into each other. Now, let us discuss some of the monetary standards based on gold that are relevant to the world economy.

1. Gold Coin Standard

The gold coin standard refers to the use of gold coins as currency, with specific weight, fineness, and shape. This ensures that the value of each coin is easily recognisable while also eliminating problems associated with non-standardised shapes. Under this standard, the government takes raw gold, known as bullion, and transforms it into coins. These coins are given a specific value based on the weight and purity of the gold they contain, ensuring that the value of the coin as currency matches the intrinsic value of the gold used to make it. Major features of this standard include the ability to trade gold coins internationally, depending on a country's balance of payments and trade needs. If needed, gold coins can also be melted down to produce bullion, which can then be reused for industrial or ornamental purposes, or re-minted into new coins.

However, the system faces some challenges. First, the supply of gold does not necessarily expand in line with the economy's growing need for a larger money supply. The availability of gold for monetary purposes depends on factors such as a nation's natural gold reserves, the current production rate determined by technology, production costs, the price of gold, and the export or import of gold due to international trade balances. None of these factors automatically adjust to meet the needs of an expanding

economy. Second, the circulation of gold coins results in losses due to normal wear and tear or debasement, where individuals remove small amounts of gold while still passing the coins at their face value. Third, the demand for gold as money competes with its non-monetary uses, such as in commercial, industrial, and ornamental applications.

2. The Gold Bullion Standard

The Gold Bullion Standard is another variation of the gold standard. The monetary unit is again defined in terms of a fixed quantity of gold. However, instead of the gold being circulated as coin, paper money convertible into gold is used as a hand-to-hand currency. This system has the virtues of avoiding the losses resulting from the circulation of gold coins and conserving the domestic supply of gold for the settlement of international payments.

3. The Gold Exchange Standard

The third variation of the gold standard is the gold exchange standard. The gold exchange standard bases the monetary reserves of one nation on the holding of claims against another nation on the Gold Bullion Standard. While the United States operated on the international Gold Bullion Standard, other nations held dollars as international backing for their currency, the dollars represented a claim against the American gold supply. Problems of the gold standard, the shortage of gold and the desire of nations to avoid the domestic policies that were acquired by the gold standard led to an increase in detachment of money from gold.

1.1.5.2 Paper Standard

Paper Standard refers to a monetary standard in which inconvertible paper money circulates as unlimited legal tender. Under the paper money standard, the standard money is made of paper, both currency and coins serve as standard money for payment. No gold reserves are required either to back domestic paper currency or to facilitate foreign payments. The paper standard is known as the 'Managed Standard' because the quantity of money in circulation is controlled and managed by the monetary authority to maintain stability in prices and incomes within the country. It is also called fiat standard because paper money is inconvertible in gold and still regarded as full legal tender. After the general breakdown of the gold standard in 1931, almost all the countries of the world shifted to the paper standard.

1.1.6 Value of Money

The value of money refers to its purchasing power, which is determined by the quantity of goods and services that can be exchanged for one unit of money. It is the measure of the money's capacity to facilitate economic transactions and its effectiveness as a medium of exchange. There are various ways to measure the value of the rupee.

1. Price Levels

The general price level and the value of money are two sides of the same coin. When prices rise, the value of money falls, and when prices fall, the value of money rises. In

other words, the value of money and the general price level are inversely proportional to each other. Sudden and drastic changes in the value of money (or the price level) disrupt economic stability and cause significant harm. Therefore, it is essential to study the factors that influence the value of money carefully. For example, imagine that we can buy 1 kg of wheat today but can purchase only half a kg tomorrow with the same amount of money. This situation reflects a decrease in the value of money. When there are more rupee notes in circulation while the quantity of goods remains constant, it is clear that the purchasing power of the rupee declines.

2. Exchange Rate

The value of money, specifically a currency like the rupee, can be measured based on the exchange rate. The exchange rate represents how much of one currency can be exchanged for another. Suppose India enters into a trade relationship with the USA. If the Indian rupee depreciates (weakens) against the dollar, it means the rupee will buy fewer foreign goods or services from the USA, signalling a decline in the value of the Indian rupee. Conversely, if the Indian rupee appreciates (strengthens) against the dollar, it increases the purchasing power of the rupee. In this case, the value of the Indian rupee rises.

3. Goods and Services

The value of money can also be measured based on goods and services, primarily by assessing its purchasing power. If a rupee buys more goods and services today compared to yesterday, its value has increased. Conversely, if it buys less, its value has decreased. For example, if you can buy 1 kg of rice for ₹40 today, but tomorrow the same ₹40 buys only 0.5 kg of rice, the value of money has declined.

When the value of money steadily declines over time, it leads to inflation. Once people expect that prices will rise in the future, they are more likely to spend money now to avoid paying higher prices later. This increases demand for goods and services, signalling to producers that they can safely pass on higher production costs to consumers. As a result, prices rise further, and inflation becomes a self-fulfilling cycle. A healthy economy can sustain a core inflation rate of 2%, which is considered manageable. Core inflation excludes volatile items like food and gas, making it a stable indicator. The Consumer Price Index (CPI) is the most common measure used to track inflation. However, when inflation spirals out of control (hyperinflation), it can severely harm the economy, reducing purchasing power and destabilising markets.

When the value of money steadily increases over time, it leads to deflation. Although this may seem beneficial at first - because goods and services become cheaper - deflation is more dangerous for the economy than inflation. For example, during the housing market crash from 2007 to 2011, house prices fell by more than 20%. As the value of money increased, people hesitated to buy homes, expecting prices to drop further. Sellers found it hard to sell properties, buyers delayed purchases, and construction workers lost jobs. Builders went bankrupt, and families lost their homes. Deflation creates a fear-driven downward spiral, where reduced consumer spending lowers demand, forcing businesses to cut jobs and lower wages, further worsening economic conditions. This deflationary cycle can cripple economic growth, making recovery difficult.

1.1.7 Index Numbers

An index number is a series of figures that measure changes in the size of an economic variable over time and across different locations. It helps in assessing variations in economic phenomena, suppose in the case of changes in the value of money. The value of money tends to fluctuate over time, with these fluctuations affecting different sectors of the economy in distinct ways. It becomes crucial to understand these changes to get a clear picture of how the value of money is evolving. To track such changes, the concept of index numbers is utilised. In advanced economies, index numbers are regularly prepared both officially by the government and unofficially by other institutions interested in studying economic shifts. The various types of index numbers exist, the primary focus here is on Price Index Numbers. These reflect changes in the general price level of goods and services, capturing fluctuations in purchasing power and influencing economic decisions.

1.1.7.1 Different Steps to Construct Index Numbers

The following are the different important steps to construct Index Numbers.

- Purpose of construction of Index Numbers
- Number and kinds of commodities
- Source of data
- Base year
- Averaging

The above five steps are common to both the simple as well as the weighted Index Numbers. Another important step that is only meant for the weighted Index Numbers is weightage.

1. Purpose of Construction of Index Numbers

The first step in the construction of index numbers is its purpose of construction. The choice of a particular Index Number depends upon the purpose which it has to serve. If our purpose is to study the problem of real and money wages of the workers, then we must prepare the Retail Price Index. But if we want to know the changes in the value of money for a businessman then it is the Wholesale Price Index, not the retail price.

2. Number and Kinds of Commodity

The second important step in the construction of an Index Number is the selection of numbers and kinds of commodities that should constitute the corpus of an index. It is necessary to select the samples which are representative of the universe. The purpose of constructing the Index Number is to measure the value of money for the entire nation because it is impossible to include the price of all known goods and services available at a particular moment.

3. Source of Data

Prices of goods and commodities are collected from different sources. Market quotations are obtained from journals, newspapers, monetary institutions, etc.

4. Selection of the Base Year

The base year is defined as that year, the average price level of which to compare with the average price level of other years. This year should be independent or free from all economic and social disturbances. That means there should be nothing abnormal happening in the base year. The base year should be selected in such a way that it should be a normal year judged from various considerations. The selection of an appropriate base year is an important consideration of index numbers.

5. Averaging

The last but not the least step of the construction of index numbers is averaging. In the preparation of the price index numbers, the average of the percentage of prices both in the base year as well as in the present year is calculated, and after that, these averages are combined. For example, suppose the base year is 2001 and all prices in that year have been collected. We want to construct an index number for 2011. Therefore, we will make a second list of prices in 2011 of the same commodities to have them in the same form. We express the percentage of 2011 prices putting the prices in 2001 as hundred.

1.1.7.2 Uses of Index Numbers

Index Numbers can be used for several purposes. Let us discuss them in detail.

1. Index Numbers are used not merely to measure changes in the price level or changes in the value of money. They can be used to measure quantitative changes. Thus, we can prepare an Index Number of wages, imports, exports, industrial production, unemployment, profits, the area under cultivation, enrollment in a college, etc.

2. The changes in the quantitative variables can be measured by index number which indicates social and economic trends and helps in framing policies concerning them. For instance, an index number of the cost of living can guide us in the adjustment of wages to changing prices.

3. We can compare the economic conditions of a class of people at two different periods.

4. Index numbers can be used as a basis for contracts relating to borrowing and lending.

1.1.7.3 Limitations

Measuring the changes in the value of the money index numbers is not an easy task. There are several difficulties involved in the construction of index numbers.

1. **Approximations:** Index numbers are at best only approximations. They

cannot be taken as infallible guides. Their data are open to question and they lead to different interpretations.

2. **International Comparisons Difficult**: The use of index numbers for international comparisons is difficult. It is not possible on account of different bases, different sets of commodities or differences in their quality, etc.

3. **Comparison between Different Times Difficult:** It is not easy to compare different periods. Over long periods, some popular commodities are replaced by others. Entirely new commodities come to figure in consumption, or a commodity may be vastly different from what it used to be.

4. **Measure Sectional Price Levels Only:** Index number measures only changes in the sectional price levels. An Index Number, therefore, prepared for a particular purpose, may not be useful for another. An Index Number that helps us to study the economic conditions of mill-hands or railway coolies will be useless for a study of the conditions of college lecturers.

5. **Weighting Changes Result:** One set of weights may yield quite a different result from another, and weighting is all arbitrary.

We may conclude in the words of Coulborn who observes, "No general price-level is in fact compiled in this way because the practical difficulties of collecting the various prices and assessing weights strictly appropriate to the base year, and approximately relevant to the subsequent ones, prove to be difficulties which are insuperable in practice."

Recap

- According to Francis Walker, "Money is what money does"
- Commodity Money refers to commodities used as money that have intrinsic value
- Metallic Money refers to money made from metals like gold, silver, copper, and tin
- Token Money is made of cheaper metals and used for transactions
- Near Money refers to assets that are close substitutes for cash and are highly liquid, such as Treasury Bills
- Money is anything that is generally accepted as a means of exchange
- Money acts as a measure and store of value, a standard of deferred payments
- The functions of money are categorised as primary functions, secondary functions, and contingent functions
- When the money supply increases, the value of money falls, leading to inflation
- Monetary Standard refers to the system of selecting a monetary unit to perform the functions designated as money

Objective Questions

1. What is the primary function of money as per traditional definition?
2. What system was used for transactions before the invention of money?
3. Which stage of money evolution involved goldsmiths issuing receipts for deposited gold?
4. Who defined money as "Money is what money does"?
5. What type of money derives its value from trust and confidence in the issuer's promise?
6. What is the term used for money that exists in digital or electronic form?

7. Which monetary system involves the use of two metals as standard money?
8. What is the main use of index numbers in economic studies?
9. What is the key feature of the Gold Coin Standard?
10. Under the Gold Bullion Standard, what serves as the primary circulating medium?

Answers

1. Medium of exchange
2. Barter System
3. Paper Money
4. Francis Walker
5. Fiduciary Money
6. Electric money
7. Bimetallism
8. Measuring changes in quantitative variables over time
9. Use of gold coins with specific weight and fineness
10. Paper money convertible into gold

Assignments

1. What are the major definitions of money?
2. What are the types of money?
3. Explain the concept of a monetary standard.
4. Elucidate the value of money.

5. Explain the concept and importance of index numbers.

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UNIT 2

Theories of Demand for Money

Learning Outcomes

After learning this unit, the learner will be able to:

- understand the classical theory of demand for money
- grasp the Keynesian liquidity preference theory of money
- get an idea about monetarist theory of demand for money

Prerequisites

Raj is a business owner who demands money to ensure the smooth functioning of his bakery. He holds cash for daily expenses like buying flour, sugar, and eggs. Occasionally, he faces higher prices and needs additional money to cover rising costs. As Raj's business grows, he encounters unexpected expenses, such as purchasing a new oven. Raj also realises the importance of holding extra cash to manage inflation, ensuring he can buy ingredients without being negatively impacted by rising prices. This means Raj holds money not only for transactions but also for precautionary purposes. However, during times of inflation, when the prices of goods increase, it negatively affects his business. He may experience financial losses, and like Raj, many other small business owners face similar challenges. Collectively, this impacts the entire economic system. In this unit, we will explain these concepts through various economic theories, including the Classical Approach, Keynesian Approach, Monetarist Approach, and Friedman's Restatement of the Quantity Theory.

Keywords

Equations of Exchange, Liquidity Preference, Transactions Demand, Precautionary Demand, Speculative Demand, Liquidity Trap

Discussion

1.2.1 Demand for Money

The demand for money refers to the desire or preference of individuals, businesses, or the government to hold a portion of their wealth in the form of money rather than in other assets like stocks, bonds, or physical goods. Money possesses the unique feature of spendability or liquidity, which distinguishes it from other types of assets. For this reason, the demand for money is sometimes referred to as the demand for liquidity.

People demand money for various purposes, such as, carrying out daily transactions or purchases, handling unexpected expenses or emergencies, and holding money as an asset to take advantage of future investment opportunities or to avoid potential losses in other assets. Based on these features, we can say that the demand for money arises from two important functions of money viz; money acts as a medium of exchange and also money serves as a store of value. The demand for money is influenced by various factors such as price levels, interest rates, and real income. Fluctuations in any of these factors can affect the demand for money, which, in turn, impacts the stability of the economy.

Various theories relate to the demand for money, including the Classical Theory, Keynesian Theory, and modern approaches like the Baumol-Tobin Model and Friedman's Restatement of the Quantity Theory. Understanding these theories is crucial as they form the foundation of monetary policy. Central banks use these insights to control inflation, stabilise prices, and promote economic growth by managing the money supply. These theories also provide valuable perspectives on how monetary and fiscal policies interact with key economic variables, such as interest rates and national income.

1.2.2 The Classical Approach to the Demand for Money

The classical economists did not explicitly formulate demand for money theory but their views are inherent in the quantity theory of money. The classical theory of demand for money is often referred to by two key names: the Quantity theory of money and the Cash transaction approach. The classical theory of demand for money focuses on the relationship between the money supply, the velocity of money, and the total output in an economy. Irving Fisher in his book 'The Purchasing Power of Money' (1911), states that people hold money primarily for transaction purposes as it facilitates the exchange of goods and services and the velocity of circulation of money is an important factor in determining the purchasing power of money. His idea is explained using his famous equation, known as Fisher's Equation of Exchange, which is denoted as;

$$MV = PT$$

Where'M' is the total quantity of money in circulation, 'P' is the price level, 'V' is

the transaction velocity of money, and 'T' is the total volume of transactions of goods and services exchanged for money. This equation can be divided into two sides, the left side and the right side. The right side **'PT'** represents the demand for money. It reflects the total value of transactions in the economy, meaning that the amount of money demanded is proportional to the value of goods and services being exchanged. This equation assumes that the demand remains constant over time.

On the left-hand side of the equation, MV represents the money supply and its interaction with velocity. Fisher's equation suggests that when the money supply increases, the price level rises proportionately, assuming V (velocity) and T (total transactions) remain constant. If the money supply doubles, the value of money falls, leading to a doubling of the price level, which reduces the purchasing power of money. Conversely, a decrease in the money supply will reduce the price level, increasing the purchasing power of money. when MV = PT the equilibrium occurs in the economy. Fisher argued that the money supply has a proportional relationship with the price level. Therefore, he emphasised that controlling the money supply is crucial for maintaining price stability.

Limitations

Fisher's cash transaction approach has been severely criticised by economists on the following grounds.

- The cash transaction approach is based on some unrealistic assumptions. According to Fisher, the fundamental determinant of the price level is the quantity of money. All other elements in the equation of exchange are constant. However, it is not correct to say that high prices are the result of expansion in the money supply. In reality, P may be active and it does influence T. The changes in T will lead to changes in V and M for a large volume of trade. It means more financial transactions which increase V and M. The Fisherian assumption of constant V is also wrong; it may also change.

- Fisher's equation of exchange MV = PT is just a mathematical truism. It reveals the monetary equilibrium supply of money is equal to the demand for money. That means it does not give any clue to the causal process in which the value of money is determined. Moreover, it did not show how an increase or decrease in the money supply reacted upon the price level. So, the Fisherian cash transaction approach is a mathematical truism but not analytical.

- It involves some sort of technical inconsistency in using M and V. In this equation, M refers to money at a point in time and V refers to the velocity of circulation over its period.

- This equation of exchange does not refer to any specific standard of value of money because PT is the amalgam of prices of all transactions, current as well as capital. So, this approach is not accepted widely.

- The transaction approach of the quantity theory of money is lopsided because it only considers the supply of money as most effective and neglects the demand for money.

- The cash transaction approach does not take into account the rate of interest which is quite important.

1.2.3 Keynesian Approach to the Demand for Money: Liquidity Preference Theory

The liquidity preference theory was developed by John Maynard Keynes in his well-known book 'The General Theory of Employment, Interest, and Money'. According to Keynes, the demand for money is a demand for liquidity. Liquidity refers to an asset that can be converted into money. Money is the only asset that has perfect liquidity. Demand for money is the demand from the people to keep money in liquid form. Keynes suggested three motives that led to the demand for money in an economy. They are:

- The Transactions Demand
- The Precautionary Demand
- The Speculative Demand

1.2.3.1 The Transactions Demand for Money

The transaction demand for money arises from the medium of exchange function of money. Most individuals receive income on a weekly or monthly basis, while their expenditure occurs daily. Therefore, a certain amount of ready cash is maintained to facilitate current payments. This amount depends on the size of an individual's income. Keynes argued that people keep cash on hand to meet their day-to-day requirements, which depend on the size of an individual's income. Therefore, the transaction demand for money is a function of income, not interest rates. This relation can be written as

$$Lt = K.Y$$

The equation states that the demand for money directly depends on the income. In this context, income is elastic while interest rates are inelastic for the transaction demand for money. Let us explain with the help of a diagram.

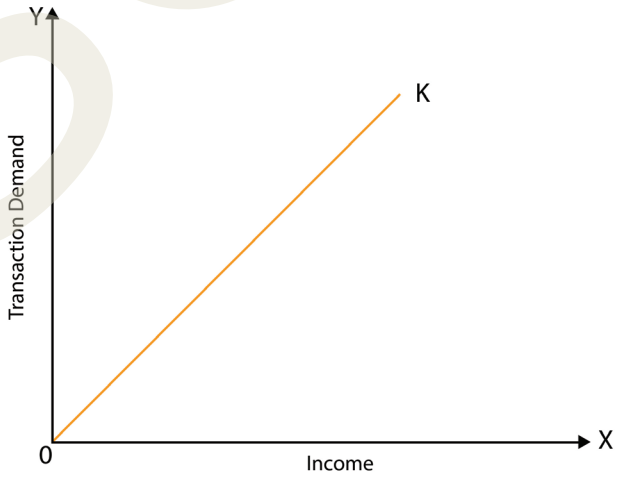

Fig 1.2.1 Transaction Demand for Money

The x-axis represents income, while the y-axis represents the transaction demand for money. Here, *K* represents the proportion of income kept for transaction purposes, and when income increases, the transaction demand for money also increases. Thus, K is upward-sloping.

1.2.3.2 Precautionary Demand

Precautionary demand for money arises primarily because of the uncertainty of future receipts and expenditures. Both individuals and business firms keep cash in reserve to meet unexpected needs. The precautionary motives related to the decision to provide for contingencies requiring sudden expenditure and unforeseen opportunities. The precautionary demand for money depends upon the level of income and business activity, opportunities for unexpected profitable deals, availability of cash, the cost of holding liquid assets, etc. According to Keynes, precautionary demand for money is a function of the level of income. Hence it can be written as

$$M_{dp} = f(Y)$$

1.2.3.3 Speculative Demand for Money

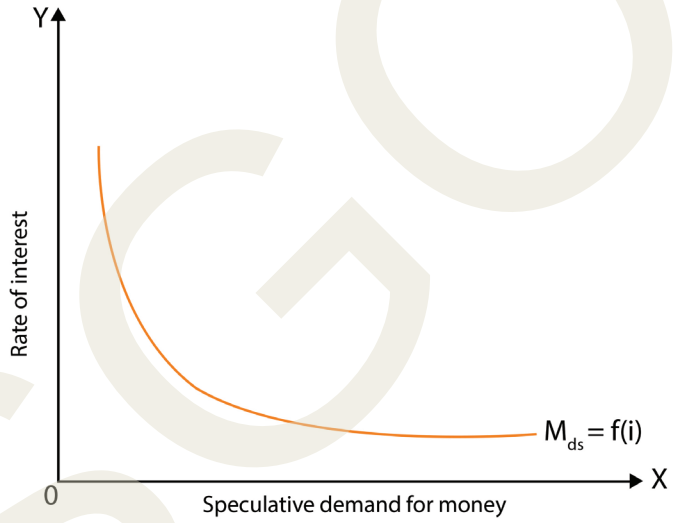

Fig 1.2.2 Speculative Demand for Money

The speculative demand for money refers to people holding money to take advantage of changes in bond prices and interest rates. Keynes states that the speculative demand for money is a function of the rate of interest. The interest rate and bond prices are inversely related. When the interest rate is currently low, people believe that it could increase in the future. If the interest rate rises, the value of bonds will decrease. To avoid losing money due to a potential decline in bond prices, people prefer to hold their money instead of investing it in bonds. On the other hand, when the interest rate is high, people believe that it could decrease in the future. If the interest rate falls, the value of bonds will increase. To benefit from the rise in bond prices, people prefer to invest their

money in bonds rather than holding it in cash. Thus, Keynes argues that speculative demand for money is inversely related to the rate of interest and can be expressed as

$$M_{ds} = f(i)$$

where 'M_{ds}' is speculative demand for money and 'i' is the rate of interest. Let us explain it with the help of following figure. It denotes that the speculative demand for money is a function of the rate of interest and it inversely depends on the rate of interest.

In the figures, it can be observed that the speculative demand curve has an inverse slope. Therefore, the total demand for money is the sum of the demands arising from these three motives.

$L = L_t + L_p + L_s$

Where:

L_t is the transaction demand for money,

L_p is the precautionary demand for money, and

L_s is the speculative demand for money.

According to Keynes, the demand for money is a function of income and the rate of interest. Thus, it can be expressed as:

$$L = f(Y) + f(r)$$

This simplifies to mean that the demand for money depends on income (Y) and the interest rate (r).This means that the money held for transactions and precautionary purposes depends on income and the money held for speculative purposes depends on the interest rate.

We have observed that speculative demand is one of the components of total money demand, and it depends on both current and expected future interest rates. The speculative demand curve is inversely related to the interest rate: as interest rates rise, speculative demand for money decreases, and as interest rates fall, it increases. When interest rates are very low, speculative demand for money becomes infinitely elastic- that is, people prefer holding large amounts of money rather than investing in low-return bonds because they do not expect interest rates to fall further. This situation creates a liquidity trap in the economy. During this period, increasing the money supply or reducing interest rates fails to stimulate investment or boost economic activity. Keynes argued that policies aimed at lowering interest rates through increasing the money supply would not be effective because people would continue to hold money rather than invest in bonds. Thus, Keynes believed that monetary policy would become ineffective in this situation. Let us explain with the help of figures.

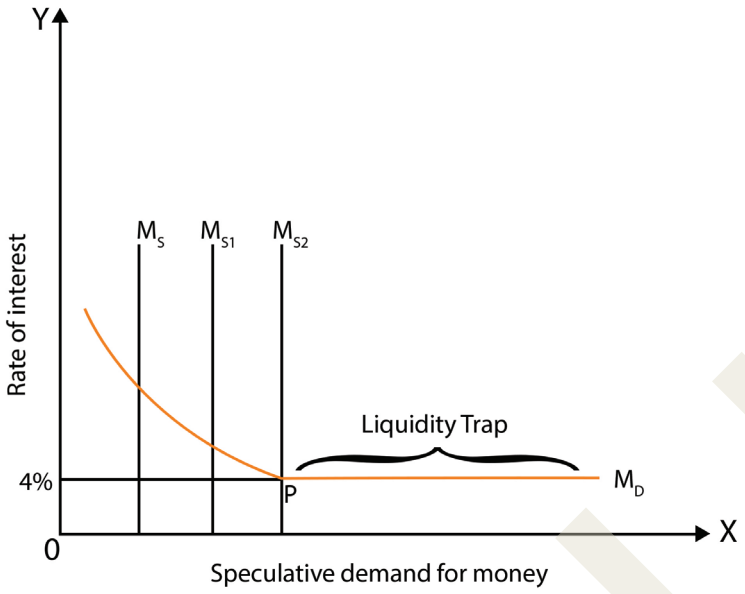

Fig 1.2.3 Liquidity Trap

The graph shows the relationship between the speculative demand for money on the X-axis and the rate of interest on the Y-axis. The downward sloping line represents the demand for money (MD), while the vertical lines labelled M_S, M_{S1}, and M_{S2} show different levels of the money supply. When the rate of interest is high, people prefer to invest in bonds rather than holding cash because bonds offer good returns. As a result, the speculative demand for money is low. As the rate of interest decreases, the returns on bonds become less attractive, and people start holding more money instead of investing in bonds. This increases the speculative demand for money.

However, when the rate of interest becomes very low (like 4% in the graph), people expect interest rates to rise in the future, which could cause bond prices to fall. At this point, people prefer to hold money rather than risky investment in bonds. In this situation, the speculative demand for money becomes perfectly elastic. This flat portion of the demand curve (from P to MD) is called the liquidity trap. In this range, monetary policy becomes less effective because increasing the money supply does not reduce interest rates further or stimulate investment.

1.2.4 Monetarist Approach to the Demand for Money

Monetarism is an economic theory that focuses on the role of the money supply in influencing economic activity. This school of thought emerged in the 1970s and 1980s. It gained prominence as a response to the Keynesian approach. Milton Friedman, a key figure in monetarism, argued that monetary policy should follow strict rules to maintain economic stability rather than rely on discretionary decisions by central banks.

Monetarism is based on four main ideas. They are:

- Monetarists believe that changes in the money supply are the primary factor influencing nominal income.

- In the short run, changes in the money supply can influence real variables like output and employment because prices and wages adjust slowly. For example, an increase in the money supply can temporarily boost production and reduce unemployment.

- In the long run, money supply affects only the price level, not real economic output. Real economic factors like technology, labour, and capital determine output and employment.

- Monetarists argue that the private sector is inherently stable and self-adjusting. Economic instability arises due to government policies, such as poor monetary management, or market interventions like price controls or rent caps.

Monetarists criticised Keynesian economics for underestimating the role of the money supply in driving economic outcomes. Keynesians believed fiscal policy such as government spending and taxation was more effective than monetary policy. Monetarists countered this by asserting the centrality of stable money supply growth for economic stability. We see that Monetarism is built on the principle that the money supply is the dominant factor affecting economic activity. This view is directly derived from Friedman's restated Quantity Theory of Money.

1.2.5 Friedman's Restatement of Quantity Theory

The Classical Quantity Theory of Money explains the direct relationship between the supply of money and the price level. Milton Friedman, in his essay *The Quantity Theory of Money: A Restatement*, published in 1956, set down a particular model of the Quantity Theory of Money, also known as the New Quantity Theory of Money or the Monetarist Approach. In his reformulation of the quantity theory, Friedman asserts that 'money does matter.' He pointed out that the quantity theory is a theory of the demand for money, not a theory of output, money incomes, or prices.

There are two types of demand for money.

a) The demand for money for transactions

b) The demand for money to serve as an asset

Friedman's theory of the demand for money is partly Keynesian and partly non-Keynesian. In identifying the key determinants of the demand for money, he classifies the holders of money as ultimate wealth holders and business enterprises. He emphasises the role of money as an asset and generalises Keynes' analysis of the speculative demand for money by treating the total demand for money as part of capital or wealth theory, concerned with the composition of the balance sheet of portfolio assets.

Friedman draws a relationship between the demand for money and the demand for durable consumer goods (such as cars, appliances, or furniture). He states that individuals decide how much of a durable object to purchase based on factors like income, price, and preferences. Similarly, they also decide how much money to hold based on similar

considerations. In this context, money is treated as an asset with specific characteristics, such as liquidity and return. The demand for money depends upon three major factors viz;

- The total wealth to be held in various forms
- The price and return on this form of wealth and alternative forms
- The tastes and preferences of the wealth-owning units

Total wealth can be held in five different forms: money, bonds, equities, physical non-human goods, and human capital. Total wealth includes all sources of income. Thus, income (Y) is one determinant of the demand for money function. Let us explain the different forms of wealth.

- Money includes currency, demand deposits, and time deposits. When prices fall, the rate of return on money is positive because the value of money increases during deflation. Conversely, if the price level rises, the rate of return on money becomes negative because the value of money decreases during inflation. Thus, the price level (P) is an important variable in Friedman's demand for money function.

- Bonds stand for assets that promise a perpetual income stream. The return of a bond is affected by the changes in the interest rate. The return from a bond is represented as 'rb'.

- Equities stand for assets that promise a perfect income stream by purchasing shares of companies in the stock market. When one invests in equities, the expectation is for appreciation of the investment through capital gains and dividends. The return on equities is represented as 're'.

- Physical non-human goods are durable goods like consumer durables, land, houses, and cars. The nominal return on durable goods is the expected increase in the price of the goods over the period for which they are held. The return from physical non-human goods is represented as 'rd'.

- Human capital refers to the productive capacity of human beings. At any given point in time, an individual wealth holder's asset portfolio will be divided in some way between non-human and human wealth. The ratio of non-human to human wealth is represented by 'W'. The variables which affect the taste and preference of wealth holders are represented by 'U'.

Friedman's theory of the demand function for money for an individual wealth holder can be represented as

$$Md = f(P, Y, rb, re, rd, W, U)$$

Where P is price level, Y is real income, rb is nominal interest rate on bonds, re is nominal returns on equities, rd is nominal return on durable goods, W is the ratio of non-human to human wealth, and U is taste and preferences.

The amount of money demanded depends on wealth, the interest rate on bonds, the rate on equity, the expected rate of inflation, the ratio of non-human to human wealth, and variables affecting the taste and preferences of wealth holders. If wealth increases, more money is demanded. If the rate of interest on bonds rises or the return on equities increases, less money is demanded. If the rate of inflation rises, the demand for money falls. The ratio of non-human to human wealth and variables that affect the taste and preferences of the wealth holders are assumed constant in the short run.

1.2.5.1 Criticism

- According to Friedman, the influence of the interest rate on the demand for money is quite minor and he concludes that the rate of interest may be ignored in describing the demand for money. The critics find that the underestimation of the effect of interest rates on the demand for money is due to the broad definition of money that Friedman has adopted.

- Many critics have questioned Friedman's analysis of the transmission of monetary change to real economic change. He assumes that a rise in M results in an appreciable rise in the price level and a fall in the real income and thus leads to a change in output and income. The critics point out that a rise in M causes a low rate of interest and increases investment, output, etc.

- Friedman uses income in the sense of permanent income. The concept of permanent income cannot be measured accurately.

- Friedman's concept of wealth is too broad and imprecise and concepts like human capital are difficult to quantify.

Recap

- According to Francis Walker, "Money is what money does."
- The spendability or liquidity is the unique feature of money that distinguishes it from other assets.
- The demand for money for unforeseen expenses is referred to as precautionary demand.
- Price level, interest rates, and real income influence the demand for money.
- Classical Approach: In Fisher's Equation of Exchange, MV = PT.
- Fisher's equation, MV = PT, assumes demand remains constant.
- According to Keynes, the three motives for holding money are transaction, precautionary, and speculative motives.
- The speculative demand for money is inversely related to interest rates.
- A liquidity trap occurs when people hold large amounts of cash and avoid bonds, according to Keynes.
- Milton Friedman's theory of the demand for money is partly Keynesian and partly monetarist.
- Friedman's concept of 'permanent income' refers to long-term average income.

Objective Questions

1. What does the 'spendability' or liquidity of money refer to?
2. Define demand for money.
3. What are the three motives for holding money according to Keynes?
4. Write Fisher's Equation.
5. What is the argument for Keynes' Liquidity Preference Theory?

6. What does the precautionary demand for money arise from according to Keynes?

7. Milton Friedman's Restatement of the Quantity Theory of Money is primarily concerned with which approach?

8. The transaction demand for money, according to Keynes, is a function of ..

9. Friedman argues that the demand for money depends on:

10. The concept of 'permanent income' in Friedman's theory refers to:

Answers

1. The unique feature that distinguishes money from other assets
2. The desire to hold money as a store of value rather than other assets
3. Transaction, precautionary, and speculative motives
4. M V = P T
5. Inversely related to interest rates
6. Uncertainty about future receipts and expenditures
7. Monetarist Approach
8. A function of income
9. The price level, real income, and the rate of interest on bonds
10. The average income over a person's lifetime

Assignments

1. Explain the classical theory of demand for money.
2. What are the major ideas of the monetarist theory of demand for money?

3. Explain the Keynesian ideas of demand for money.

4. Elucidate the restatement of the quantity theory of money.

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UNIT 3

Money Supply

Learning Outcomes

After learning this unit, the learner will be able to:

- understand the basic concepts of money supply
- know the process of money multiplier
- get an idea about the Indian Currency System

Prerequisites

Imagine you live in a small village where everyone relies on barter to trade. Rina, the farmer, needs shoes, so she gives vegetables to Sam, the cobbler, in exchange for footwear. But what happens if Sam does not need vegetables? This creates inconvenience and inefficiency, making people realise the need for a common medium of exchange - something everyone would accept. And so, the idea of money is born.

As more people begin to use money, its value can decrease if there is too much in circulation, leading to inflation. Inflation negatively impacts the economy, reducing the purchasing power of money and causing hardship for businesses and individuals alike. To control these issues, a proper system must be in place to regulate the supply of money.

In today's economy, the circulation of money is carefully controlled. For example, each rupee note you hold carries the signature of the Governor of the Reserve Bank of India (RBI), signifying its authenticity. But why can't you print your own money? Because a country's central bank, such as the RBI, ensures economic stability by regulating the money supply.

The RBI decides how many notes to print and carefully balances the money

in circulation. Its role is to ensure there is enough money to support trade and economic activity without flooding the market, which could lead to inflation. This system not only gives value to money but also ensures trust and stability in the economy. In this unit, we will learn about the supply of money, including its definitions, determinants of money supply, the money multiplier, and the Indian currency system.

Keywords

Money Supply, Cash Reserve Ratio, Money Multiplier, High-Powered Money, Currency System

Discussion

1.3.1 Supply of Money

The money supply refers to the total amount of money available in an economy at a given time. It includes all currency in circulation and deposits held by the public in banks, excluding holdings by the central government and commercial banks. The money supply is considered a stock when measured at a specific point in time and a flow when observed over a period. There are three alternative views regarding the definition of the money supply.

- **Traditional View**

The most common view, associated with traditional economics, defines the money supply as the sum of currency held by the public and demand deposits with commercial banks. This is considered the narrow view of the money supply. Its emphasis is the medium of exchange function of money

- **Friedman's View**

A broader definition is associated with Friedman, who includes currency held by the public, demand deposits, and time deposits with commercial banks. He emphasises money's role as a store of value.

- **Gurley and Shaw's View**

The broadest definition, associated with Gurley and Shaw, defines the money supply as M2 (currency + demand deposits + time deposits) along with deposits in savings banks, building societies, and other credit and financial institutions.

1.3.2 Determinants of Money Supply

The determinants of money supply are factors that influence the total amount of money circulating in an economy. There are three determinants of the money supply. They are

- Cash Reserve Ratio,
- Excess reserves of commercial banks, And
- Public currency holdings.

1. Cash Reserve Ratio

CRR is the percentage of the deposits of commercial banks statutorily kept with the central bank of a country. An increase in the CRR will result in a reduction in the excess reserves of commercial banks used for credit creation. This will adversely affect the supply of money. Conversely, A reduction in CRR will result in an increase in the excess reserve of commercial banks and hence an increase in the supply of money.

2. Excess Reserves of Banks

The level of excess reserves of banks is the most important determinant of the money supply. Excess reserves are the difference between total reserves and required reserves. Excess reserves are used for credit creation. Thus, higher the excess reserves the higher the supply of money and vice versa.

3. Public's Currency Holdings (Currency Deposit Ratio)

Public's desire to hold currency relative to bank deposits is another determinant of the money supply. The demand to hold bank deposits arises from their convenience and safety in transferring large sums of money. If people hold money more in terms of bank deposits, the reserves will increase and lead to an increase in the money supply.

1.3.3 Money Multiplier

The money multiplier explains how the banking system expands the money supply based on the monetary base and the reserve ratio. High-powered money refers to the currency issued by the Government of India and the Reserve Bank of India (RBI). It is also known as base money or 'powerful money.' High-powered money includes both the currency held by the public (paper money and coins) and the reserves held by the government and commercial banks with the RBI. Therefore, high-powered money (H) can be expressed as:

$$H = C + R$$

Where:

H represents high-powered money,

C is the currency held by the public (paper money + coins),

R is the reserves held by the government and commercial banks with the RBI.

This concept illustrates how an initial deposit can lead to a greater overall increase in the money supply. When banks receive reserves, they lend out a portion, creating new deposits and increasing the money supply. Each unit of reserves generates a multiple of new money, depending on the reserve ratio. The money multiplier formula is:

$$Money\ Multiplie\ r = \frac{1}{Reserve\ Ratio}$$

Suppose a customer deposits ₹1,000 in the bank. This is the initial deposit. Out of this, 10% of the deposit, which is ₹100, must be kept as reserves, while the remaining 90%, or ₹900, can be lent out by the bank. The borrower deposits the ₹900 into another bank account, creating a new deposit. The second bank lends out 90% of this amount, which is ₹810. This process continues, creating additional deposits at each step. Thus, the total money created from the initial ₹1,000 deposit is ₹1,000 + ₹900 + ₹810 + ₹729 + ...

Here we use the money multiplier formula:

Money Supply = $\frac{1}{0.10}$ =10

The total amount of money created from the original ₹1,000 deposit is ₹10,000. That is ₹1,000 × 10 = ₹10,000.

The money created via loans is deposited again, leading to a multiplication of the money supply. In the above example, the total money supply could increase by up to ₹10000 (i.e., ₹1000 initial deposit × 10 money multiplier).

1.3.4 Indian Currency System

The Indian currency system is an essential part of the country's economy. The Indian Rupee (₹) is the official currency, subdivided into 100 paise. It is issued and managed by the Reserve Bank of India (RBI) in collaboration with the Government of India. The RBI is responsible for issuing banknotes, while coins are designed and minted by the Government. The legal tender includes all valid banknotes and coins as recognised by law. The RBI ensures the smooth circulation of currency, manages its quality, and facilitates the replacement of damaged or old notes and coins. Understanding the currency system helps in appreciating how money flows and functions in our daily lives. Let us go through the details of this topic.

1.3.4.1 Basic Factor In The Indian Currency System

1. Indian Rupee symbol

The Indian currency is called the Indian Rupee (INR). One Rupee is subdivided into

100 Paise. The symbol of the Indian Rupee is ₹, which combines elements from the Devanagari script 'र' and the Roman capital letter 'R,' with a double horizontal line at the top.

2. Legal Tender Money

According to the Coinage Act, 2011, coins of ₹1 or more can be used for payments up to ₹1,000. Fifty paise coins can be used for payments up to ₹10. People are not required to accept coins or notes beyond these limits, but they can choose to do so voluntarily if they wish. All banknotes issued by the Reserve Bank of India (RBI) in denominations of ₹2, ₹5, ₹10, ₹20, ₹50, ₹100, ₹200, ₹500, and ₹2,000 remain legal tender unless withdrawn from circulation. ₹1 notes issued by the Government of India are also legal tender. Legal tender refers to coins or banknotes that are recognised by law for settling debts or payment obligations. However, the ₹500 and ₹1,000 banknotes of the Mahatma Gandhi Series, issued until November 8, 2016, are no longer valid after demonetisation.

3. Currency Chest And Small Coin Deposit

A currency chest is a storage facility where banknotes and coins are stocked by the Reserve Bank of India. Select scheduled banks are authorised to establish these chests, which act as storehouses to distribute banknotes and coins to bank branches within their area of operation. As of March 31, 2024, there are 2,794 currency chests. A small coin depot is a facility established by select banks to stock and distribute small coins (coins below ₹1) to bank branches within their area of operation. As of March 31, 2024, there are 2,460 small coin depots.

4. Production and Distribution of Bank Notes and Coins

In India, banknotes are printed at four presses. Two owned by the Government of India through the Security Printing and Minting Corporation of India Ltd. (SPMCIL), located at Nasik (Western India) and Dewas (Central India); and two owned by the Reserve Bank of India through Bharatiya Reserve Bank Note Mudran Private Ltd. (BRBNMPL), located at Mysuru (Southern India) and Salboni (Eastern India). Coins are minted at four mints owned by SPMCIL: Mumbai, Hyderabad, Kolkata, and NOIDA. Coins are issued for circulation exclusively through the Reserve Bank under Section 38 of the RBI Act.

1.3.4.2 Role of The Reserve Bank of India In Currency Management

Under Section 22 of the RBI Act, the RBI holds the right to issue banknotes in India. According to Section 25, the design, form, and material of banknotes are approved by the Central Government, based on recommendations from the RBI Central Board. The RBI, in consultation with the Central Government and stakeholders, estimates the quantity of banknotes needed and places indents with printing presses. The RBI ensures good-quality banknotes are circulated while soiled or damaged ones are destroyed. For coins, the RBI's role is limited to distributing those supplied by the Government of India, as per the Coinage Act, 2011. Information regarding the supply of banknotes and

coins or their circulation is available on the RBI website at www.rbi.org.in or directly at the Annual Report of RBI.

The Reserve Bank manages currency operations through 19 issue offices located across India. These offices receive fresh banknotes from printing presses and distribute them to currency chests. The Reserve Bank's mint linked offices in Hyderabad, Kolkata, Mumbai, and New Delhi receive coins from mints and send them to other RBI offices, which in turn distribute them to currency chests and small coin depots. These are further distributed to bank branches, ensuring public access to banknotes and coins.

The RBI decides on the design, form, and material of banknotes in consultation with the Central Government. The final design and figures printed on the banknote are approved by the Central Board of the RBI. The RBI decides how many and what value of banknotes to print based on factors such as population growth, economic conditions, inflation, and the need to replace old or damaged notes. The RBI estimates these needs and plans accordingly with the Government of India and printing presses. The banknotes issued by the RBI are backed by assets like gold, government securities, and foreign currency, as stated by Indian law in the RBI Act.

1.3.4.3 Banknotes

Indian banknotes feature the sentence 'I promise to pay,' which means that the Reserve Bank of India (RBI) guarantees to pay the value of the banknote whenever it is presented for payment. According to Indian law, RBI is responsible for paying the amount mentioned in the banknote when requested. The paper used to make banknotes in India is made from 100% cotton, making the notes strong and durable. Indian banknotes feature 15 different languages, apart from Hindi, which is prominently displayed in the centre, and English, which appears on the reverse side of the note. While two or more banknotes may have the same serial number, there will be differences such as the inset letter (an alphabet), the year of printing, or the signature of different RBI governors. Some banknotes may have no inset letter at all.

To improve efficiency and reduce printing costs, a non-sequential numbering system is followed. Non-sequential numbering means that banknotes are printed with random serial numbers. Instead of numbering them in order (1, 2, 3, etc.), each packet of 100 notes will have unique but random numbers. For identifying replacement notes, a 'star series' system is used. A 'star series' banknote has a special star symbol (*) in the serial number. These notes are replacements for defective ones. They look exactly like other banknotes but have a star mark, which helps in identifying them.

Bank notes of ₹10, ₹20, ₹50, ₹100, ₹200, ₹500, and ₹2,000 are currently in circulation. The banknotes of ₹2 and ₹5 have been discontinued and replaced by coins because printing and handling those notes became costly. However, old ₹2 and ₹5 notes are still legal tender and can be used for transactions. ₹1 notes issued by the Government of India are also legal and continue to be accepted. Banknotes cannot only be issued in specific denominations. According to the RBI Act, banknotes can be printed in amounts like ₹2, ₹5, ₹10, ₹20, ₹50, ₹100, ₹500, ₹1,000, ₹5,000, and ₹10,000, depending on the need, as recommended by the RBI. The highest denomination note ever printed by the

RBI was ₹10,000. It was first introduced in 1938 and later demonetised. ₹10,000 notes were reintroduced in 1954 but were again demonetised in 1978. Now let us discuss the types of banknotes issued since independence.

1. Ashoka Pillar Banknotes

The first banknotes of independent India featured the Ashoka Pillar from Sarnath as their prominent design. The ₹1 note was introduced in 1949, marking the beginning of independent India's currency system. Higher denominations such as ₹1000, ₹5000, and ₹10000 were issued in 1954. These banknotes incorporated special designs reflecting India's rich cultural heritage, with motifs representing Indian art, science, and progress. This series continued to be in circulation until 1992, symbolising the nation's identity and evolution.

2. Mahatma Gandhi (MG) Series – 1996

The Mahatma Gandhi (MG) Series – 1996 introduced banknotes featuring the portrait of Mahatma Gandhi, replacing the earlier Ashoka Pillar design. This series included various denominations. ₹5 (introduced in 2001), ₹10 (introduced in 1996), ₹20 (2001), ₹50 (1997), ₹100 (1996), ₹500 (1997), and ₹1000 (2000). The design emphasised the national identity, highlighting Mahatma Gandhi's role as a key figure in India's struggle for independence.

Mahatma Gandhi Series – 2005

The Mahatma Gandhi Series – 2005 introduced improved security features compared to the 1996 series. These included elements like enhanced watermarking, colour shifting inks, and intaglio printing to make the banknotes more secure. The denominations issued under this series were ₹10 (introduced in 2006), ₹20 (2006), ₹50 (2005), ₹100 (2005), ₹500 (2005), and ₹1000 (2005).

The Mahatma Gandhi Series – 2016

The Mahatma Gandhi (New) Series – 2016 brought in new designs that emphasised India's culture, history, and achievements. This series aimed to enhance the visual appeal and maintain high-security standards. The denominations issued under this series were ₹2000 (2016), ₹500, ₹200, ₹100, ₹50.

The ₹500, ₹1000, and ₹10000 banknotes were first demonetised in 1946, reintroduced in 1954, and subsequently withdrawn again in 1978. On November 8, 2016, the ₹500 and ₹1000 notes from the 2016 Mahatma Gandhi (MG) series were withdrawn from circulation. Regarding pre-2005 banknotes, they were withdrawn due to their lack of sufficient security features. These older banknotes have been gradually removed from circulation and can only be exchanged at specific Reserve Bank offices.

Banknotes can become soiled, mutilated, or imperfect over time due to regular use or damage. A soiled note is one that has become dirty or worn out and may also include two pieces of the same note pasted together, as long as no essential part is missing. A mutilated banknote refers to a note that is damaged, has missing parts, or is composed of more than two pieces. An imperfect banknote is one that is partially damaged, torn,

washed, or altered but remains complete, unlike a mutilated note. Such damaged notes can be exchanged for their full or partial value, depending on their condition. All banks, including commercial banks, small finance banks, and payment banks, are authorised to accept soiled and mutilated notes from both customers and non-customers. The value of a damaged note is determined by how much of it remains intact. If over 80% of the original note is intact, you will receive the full value. However, if less than 40% of the note is intact, it holds no value. These rules are governed by the RBI (Note Refund) Rules, 2018, ensuring a clear process for the exchange of damaged currency.

1.3.4.4 Coins

India's Government is responsible for designing and producing coins in different denominations. The Government decides on the quantity of coins to be minted based on the Reserve Bank of India's yearly requests. Currently, India uses coins in these denominations: 50 paise, 1 rupee, 2 rupees, 5 rupees, 10 rupees, and 20 rupees. Coins below 50 paise are referred to as 'small coins,' while coins of 1 rupee or more are termed 'Rupee coins.' According to the Coinage Act, of 2011, coins can be issued up to 1000 rupees. Coins of 25 paise have been withdrawn from circulation since June 30, 2011, while coins below 25 paise were removed much earlier. All other coins continue to remain valid. One-rupee notes are considered legal tender and treated as coins under the Reserve Bank of India Act, of 1934. Since the Government of India issues rupee coins, the one-rupee note is also regarded as their liability.

Recap

- The money supply refers to the total amount of money available in an economy at a given time.
- The traditional view emphasises the medium of exchange function of money.
- Friedman highlights money's role as a store of value.
- Cash Reserve Ratio, excess reserves of commercial banks, and public currency holdings determine the money supply in an economy.
- CRR is the percentage of deposits that commercial banks are statutorily required to keep with the central bank of a country.
- The money multiplier explains how the banking system expands the money supply based on the monetary base and the reserve ratio.
- H refers to high-powered money, which is the sum of currency held by the public and bank deposits with the RBI.
- Under the Coinage Act, 2011, coins can be issued up to a maximum denomination of ₹1,000.

- A currency chest is a storage facility for banknotes and coins maintained by the RBI.
- Currency recognised by law for settling debts and payment obligations is referred to as 'legal tender.'
- Indian banknotes are printed using 100% cotton material.
- Indian currency is issued and managed by RBI.
- RBI is responsible for issuing bank notes.
- Coins are designed and minted by Government.

Objective Questions

1. What is money supply refers to?
2. What is the meaning of the money supply according to the traditional view?
3. According to Friedman, the money supply includes which factors?
4. What is the broadest definition of the money supply according to Gurley and Shaw?
5. Define Cash Reserve Ratio (CRR).
6. What happens due to an increase in CRR?
7. Define High-powered money.
8. What does the Indian Rupee symbol (₹) represent?
9. How much paise makes one Indian Rupee?
10. Which denominations of coins are currently in circulation in India?

Answers

1. The total amount of money in circulation and held as deposits by the public.
2. Demand deposits with commercial banks.

3. Currency, demand deposits, and time deposits with commercial banks.
4. M4 (currency + demand deposits + time deposits + savings and other deposits).
5. The percentage of commercial bank deposits kept with the central bank.
6. A decrease in excess reserves and a reduction in the money supply.
7. The sum of currency with the public and reserves held by commercial banks with the RBI.
8. Devanagiri script
9. 100
10. ₹1 to ₹20

Assignments

1. Explain the major definitions of money
2. What are the major determinants of money supply?
3. Explain the process of the Money Multiplier.
4. Elucidate the Indian Currency System

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BLOCK

Commercial Banks

UNIT 1

Functions and Role of Commercial Banks

Learning Outcomes

Upon completion of this unit, the learner will be able to

- be aware of the origin of commercial banks
- understand the various functions of commercial banks in an economy
- know the role of commercial banks in economic development

Prerequisites

We are all familiar with the term Bank and most of us use banking facilities for some purpose or the other. Very simply, a bank is a financial institution which accepts deposits and lends money. But in the modern world, the banking system has undergone several changes in its functions and ways of doing business. Its role in the development of an economy has become crucial. In this context the study of the banking sector assumes great importance.

India is on the threshold of economic growth. Rapid changes are taking place in almost all the fields of the Indian economy. We can see a sea change in the banking system also. This unit discusses the origin, functions, and role of commercial banks.

Keywords

Commercial banks, Savings deposits, Fixed deposits, Advancing loans

Discussion

2.1.1 Origin of Commercial Banks

The term 'bank' is derived from the Italian word "Banco" which means desk or bench. During the Renaissance period, the persons doing lending functions carried out their transactions on a desk covered by a green table cloth. In ancient Rome and Greece, the practice of storing precious metals and coins and lending out money for private purposes for interest was prevalent. In England, banking had its origin with the London goldsmiths. As a public enterprise, banking made its first appearance in Italy when the Bank of Venice was founded in 1157.

According to Crowther, modern banking has three ancestors.

1. The Merchant
2. The Goldsmiths
3. The Moneylender

The Merchant: Remittances of money from one place to another is very essential for any trading activity. Because of the chance of theft of metallic money during transportation, the traders began to issue documents that were taken as titles of money. These letters of transfer were known as "Hundi". Through hundi, the banker directs another banker to pay the bearer of hundi the specified amount of money and debit the amount from the drawer of hundi. Thus, the merchant bankers played an important role during the early stages of the evolution of Banking.

Goldsmiths: Earlier days money consisted of gold and silver. Because of the danger of theft, people started leaving their precious bullion and coins in the custody of goldsmiths. As this practice of safekeeping others' money became widespread, goldsmiths began to impose charges for safekeeping services.

Money Lender: The next stage in the development of banking arises when the goldsmiths became the lenders of money. The goldsmith realised that it was not necessary to hold 100% of the coins deposited with them. They realised that daily withdrawals were equal to daily deposits, and only a contingency reserve was required for the period when the withdrawals exceeded deposits. The goldsmith loaned out the remaining deposit on interest, after keeping the contingency reserve. Thus, the goldsmiths started performing the two major functions of banks i.e., receiving deposits and lending money.

Meaning and Definitions of Bank

A bank is a financial institution that accepts deposits from the public, makes the fund available to those who need them, and helps in the remittances of money from one place to another. Prof. Sayers defines a bank as "an institution whose debts (bank deposits) are widely accepted in settlement of other people's debts to each other". According to Crowther, a bank "collects money from those who have it to spare, or who are saving it

out of their incomes, and it lends this money to those who require it". According to the Indian Companies act 1949, banking means "accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft or otherwise",

Characteristics of Modern Banks

The important features of modern commercial banks are the following:

1. It is a commercial institution. It aims to create profit.
2. It accepts deposits and advances loans.
3. It deals with credit. It can create credit.

2.1.2 Functions of Commercial Banks

A commercial bank is a financial institution that accepts deposits from the public, gives loans for consumption and investment activities and makes a profit. These banks have a significant role in a country's economy. Commercial banks perform a variety of functions. The basic functions performed by the commercial banks are given below:

- Primary Functions
- Secondary Functions

2.1.2.1 Primary Functions

The primary functions of a commercial bank are:

1. Accepting deposits
2. Lending money or Advancing of Loans

1. Accepting Deposits

To attract savings from the public the banks maintain different types of accounts. The following are the different types of accounts.

1. Savings Deposits - These deposits are preferred by individuals with a fixed income. These accounts aim to encourage small savings of the public. A cheque facility is provided to the depositors.

2. Fixed Deposits – In these deposits, money is deposited for a fixed period - say one, two or five years – and cannot be withdrawn before the maturity period. The rate of interest is higher when compared to other deposits. These deposits are also referred to as Time deposits.

3. Current Deposits – These accounts are generally maintained by businessmen. In these deposits, the account holders are allowed to deposit and withdraw

money whenever needed. Overdraft facility (the account holders are allowed to withdraw more than their deposits) is available in the case of the Current Account.

4. Recurring Deposits – Money in these accounts is deposited in monthly instalments for a fixed period. The amount is repaid to the depositors with interest on the maturity date. The purpose of these deposits is to encourage regular savings by the public.

2. Lending Money or Advancing of Loans

Another important function of a bank is to advance loans to the public. Usually, banks retain a small reserve before lending money to needy borrowers. Before advancing loans, the bank satisfies themselves about the credit worthiness of the borrowers. Various types of loans granted by the banks are given below:

a. Cash Credit – Cash credits are loans given to borrowers against their current assets such as shares, stocks, bonds etc. The bank opens an account in the name of the borrower and allows to withdraw money up to a certain limit as determined by the value of his current assets. Interest is charged only on the amount withdrawn from his account.

b. Overdraft - The bank provides an overdraft facility to its current account holders, through which they are allowed to withdraw more than their deposits. Interest is charged only on the amount withdrawn.

c. Discounting of Bills of Exchange – This is another important method of lending by commercial banks. A Bill of Exchange is a written acknowledgement of the debt, written by the creditor and accepted by the debtor. Under this method, a holder of a bill of exchange can get it discounted by the bank. In the case of a bill of exchange, the debtor accepts the bill drawn upon him by the creditor. The debtor agrees to pay the amount mentioned to the holder of the bill on maturity. After taking some amount as commission, the bank pays the value of the bill to the holder. We will discuss more about of the bill of exchange in Unit 3 of this Block.

d. Term Loans – The banks also advance medium and long-term loans. The maturity period for these loans is more than one year. The interest is charged on the entire amount of the loan.

e. Money at Call and Short Notice – These short period loans can be called back at a very short notice of - say 1 day to 14 days. These loans are made to other banks or financial institutions.

3. Credit Creation: -

Credit Creation is a unique function of a commercial bank. Whenever a bank advances a loan to its customer, it does not lend in cash, but opens an account in the name of the borrower and credits the amount of his loan to this account. Thus, whenever a bank grants a loan, it creates an equal amount of bank deposits. This process is known as credit creation by banks. Banks can create credit many times more than their deposits.

2.1.2.2 Secondary Functions

The Secondary Functions of Commercial Banks includes agency services and general utility services provided by banks.

a. Agency Services

The bank acts as an agent of its customers for various services. The various agency services of commercial banks are the following:

a. Collecting bills, cheques, drafts, promissory notes etc.

b. Remittance of funds from one place to another through cheques, drafts etc.

c. Banks also act as a representative for the purchase and sale of shares, stocks, bonds, debentures etc.

d. Paying the insurance premium, rent, loan instalment etc. on behalf of the customers.

e. Preparing income tax returns, claiming tax refunds etc.

f. Collection of dividends and interest on shares and debentures.

g. Acting as an executor, trustee, or administrator of the estate of a customer.

b. General Utility Services

In addition to the agency services, banks provide a variety of general utility services such as:

a. Traveller's cheques – Banks issue traveller's cheques to their customers which helps them to travel without the fear of theft or loss of money.

b. Locker Facility – Offering locker facility for keeping valuables and important documents in safe custody.

c. Collection Statistics – Banks collect statistics giving important information relating to industry, trade and commerce, money, and banking, etc. They publish journals with research articles on economic and financial matters.

d. Banks also issue debit cards, credit cards, etc.

e. Underwriting securities – Banks underwrite the securities issued by the Government, public, or private bodies.

f. Letter Credit – Banks issue letters of Credit to their customers certifying their creditworthiness. Letters of Credit are used in foreign trade.

g. Gift Cheques – Some banks issue cheques of various denominations- say Rs 51, Rs101, Rs 501 etc. to be used on auspicious occasions.

h. Foreign Exchange Business – Some banks dealing with foreign currencies, may finance foreign trade by discounting foreign bills of exchange.

2.1.3 Structure of the Commercial Banking System in India

The commercial banking structure in India consists of scheduled commercial banks and non-scheduled banks. Within the scheduled commercial banks, there are public sector banks, private sector banks, and foreign banks. The structure of commercial banks is represented below.

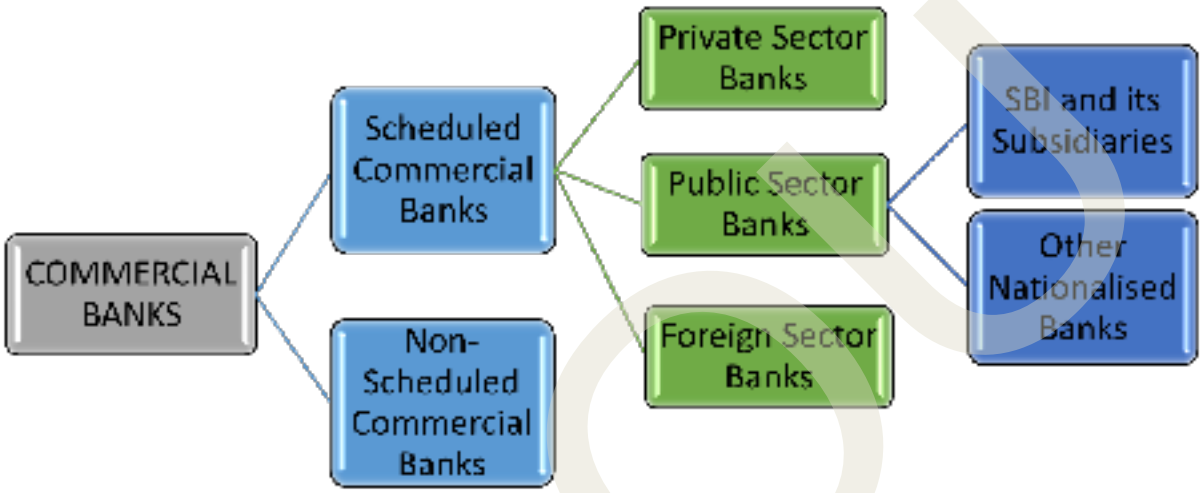

Fig 2.1.1 Structure of Commercial Banks

2.1.4 Role of Commercial Banks in Economic Development

Commercial Banks play an important and active role in the economic development of a country. In the modern world, a strong banking system is recognised as a major engine of growth. An effective banking system brings about rapid growth in various sectors of the economy. Besides performing the usual banking functions, the banks play an effective role in the economic development of developing countries. In the underdeveloped or developing countries, most of the people are poor, unemployed and are engaged in agriculture activities. The means of transport in such countries are likely to be undeveloped. There will definitely be a shortage of capital. Commercial banks help in solving these problems and promote economic development.

Commercial banks can contribute to a country's economic development in the following ways:

1. **Accelerating the rate of capital formation**: Capital is a crucial factor in the economic development of a country. Banks play a vital role in capital formation which is essential for the economic development of a country. They mobilise the small savings of the people and make it available for

productive purposes. If the banks do not do this function, the savings remain idle.

2. **Credit Creation**: Banks are able to create credit much more than their deposits. Credit creation leads to an increase in the production, employment and sales and thereby causes faster economic development.

3. **Encouragement to Entrepreneurial Innovations**: Entrepreneurs in under-developed countries hesitate to invest in new ventures due to a lack of funds. Banks facilitate loans to the entrepreneurs to start new ventures and thereby increase the productive capacity of the economy. An example is the lending made by banks to the start-ups.

4. **Fuller utilisation of resources**: Savings collected by banks are utilised for the development of different regions in the country. It ensures more utilisation of human, and natural resources of a region.

5. **Promotion of Trade and Industry**: Banks help in the promotion of Trade and Industry. Banks provide a number of services to the trading community. Such facilities enhance the ease of doing business and thereby promote trade. Banks provide medium- and long-term loans to the right type of industries. Thus, they help not only in the industrialisation of the country but also in the economic development of the country.

6. **Implementation of the monetary policy**: Money supply is to be regulated for maintaining stability of the economy. Too much money circulation causes inflation. Inadequate money supply leads to deflation. Avoiding both is a major objective of the monetary policy of a nation. A well-developed banking system is essential for the effective implementation of the monetary policy. Control and regulation of credit by the monetary authority are possible only with the help of the banking system.

7. **Monetisation of the Economy**: Banks allow money to play an active role in the economy. They help in the monetisation process in two ways:

   i. They monetise debts, which means they buy debts (i.e., Securities which are not acceptable as money) and in exchange create demand deposits (which are acceptable as money).

   ii. By starting their branches in the rural and backward areas, the banks convert the non-monetised sectors into monetised sectors.

8. **Development of Agriculture**: The commercial banks help the agricultural sector in developing countries in many ways. They provide finance directly to farmers for the marketing of their produce, for providing irrigation facilities, for developing land, for the modernisation and mechanisation of the farms etc. They also provide financial assistance for dairy farming, poultry farming, sheep breeding, animal husbandry and horticulture. Apart from agriculture, banks also give credit to small scale industries at a concessional rate of interest.

9. **Balanced Regional Development**: Banks play an important role in achieving balanced regional development in the economy. They can transfer surplus funds from the developed regions to the less developed regions. This reallocation of funds between regions will promote economic development in under-developed areas of the economy. To assist the rural areas, banks have opened their branches in rural and remote areas.

10. **Generate Employment opportunities:** Since banks promote trade and industry, they automatically generate employment opportunities. By doing a lot for the promotion of agriculture, industry, and other sectors of an economy, banks facilitate economic development. Higher economic growth generates more employment.

Recap

- The term 'bank' is derived from the Italian word "Banco"
- Modern banking has three ancestors - The Merchant, the Goldsmith, the Money lender
- Bank - financial institution that accepts deposits from the public and lends money
- Commercial Banks have both Primary and Secondary Functions
- Savings Accounts aim to encourage small savings of the public
- In a Fixed Deposit money is deposited for a fixed period, say 1, 2 or 5 years
- Fixed Deposits are also known as Time Deposits
- Current Deposits are generally maintained by businessmen
- Overdraft facilities are available to Current Account Holders
- The purpose of Recurring Deposits is to encourage regular savings by the public
- Cash credits are loans given to borrowers against their current assets
- Overdraft facility enables the Current Account Holder to withdraw more than their deposits
- Banks can create credit many times more than their deposits
- The Secondary Functions of a Commercial Bank includes both Agency Services and General Utility Services

- Commercial Banks play an important and active role in the Economic Development of a country
- Banks monetise debts, which means they buy debts and in exchange create demand deposits,
- Banks start branches in the rural and backward areas and convert the non-monetised sectors into monetised sectors.

Objective Questions

1. What is a Bank?
2. Who were the ancestors of modern banking?
3. What is Hundi?
4. Which are the two important functions of a Commercial Bank?
5. Which are the primary functions of a Commercial Bank?
6. What is a Savings Account?
7. What do you mean by Fixed Deposit?
8. Who can open a Current Account?
9. What is a Recurring Deposit?
10. Which are the different types of loans granted by a Commercial Bank?
11. What is Cash Credit?
12. What do you mean by Overdraft?
13. What is a Term Loan?
14. What do you mean by Money at Call and Short Notice?
15. What is Credit Creation?
16. Which are the two secondary functions of a Commercial Bank?
17. Which are the two agency services of a Commercial Bank?
18. Which are the general utility services of a Commercial Bank? [Name any two]

Answers

1. A financial institution that accepts deposits from the public and lends money.
2. The Merchant, the Goldsmith and the Moneylender
3. Letters of Transfer used by the Merchant
4. 1) Primary Functions 2) Secondary Functions
5. Accepting deposits and Lending money or Advancing of Loans
6. These accounts aim to encourage small savings of the public.
7. Money is deposited for a fixed period
8. A businessman
9. Money in these accounts is deposited in monthly instalments for a fixed period.
10. Cash credits, Overdrafts, Term loans and Money at Call and Short Notice.
11. Loans given to borrowers against their current assets.
12. Withdraw more than their deposits.
13. Term Loans are medium- and long-term loans with a maturity period of more than one year.
14. These are short period loans - say 1 day to 14 days.
15. Banks can create credit many times more than their deposits.
16. 1) Agency Services, 2) General Utility Services.
17. 1) Collecting Bills, Cheques, Drafts etc of customers, 2) Paying the insurance premium, rent etc on behalf of the customers.
18. 1) Locker Facility, 2) Issue of Travellers Cheques.

Assignments

1. What is a Commercial Bank? Discuss the different functions performed by the Commercial Bank.
2. Explain the different types of Accounts maintained in a Commercial Bank.
3. Explain the agency services provided by a commercial bank.
4. Which are the general utility services provided by a Commercial Bank.
5. Discuss the role played by the Commercial Banks in the Economic Development of a country.

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UNIT 2

Credit Creation

Learning Outcomes

Upon completion of this unit, the learner will be able to:

- understand the credit creation process in banking system
- familiarise with different types of deposits
- know about credit multiplier

Prerequisites

Credit means getting the money now by a promise to pay at some time in future. Credit may be defined as "the right to receive payment or the obligation to make payment on demand or at some future time on account of an immediate transfer of goods." The words credit, debt and loan are used as similar words. The word credit is derived from the Latin word 'credo' which means 'I believe'. The creditor believes that the debtor will return the loan and so decides to give the loan. Advancing loan depends mainly on confidence, character, capacity, capital, and collateral of the debtor.

Credit Creation is the most important function performed by a commercial bank. Banks have the ability to expand their demand deposits as a multiple of their cash reserves. Multiple expansion of deposits by banks is called Credit Creation. Demand deposits are an important part of money supply, and the expansion of demand deposits means expansion of money supply.

Keywords

Primary Deposits, Secondary Deposits, Cash Reserve Ratio, Credit Multiplier, Credit Creation

Discussion

2.2.1 Credit Creation

Bank credit means bank loans and advances. A bank cannot lend out all its demand deposits. A bank keeps a certain percentage of its deposits as a minimum reserve for meeting the demand of the depositors and lends out the remaining excess reserve to earn profit (The borrower is unlikely to withdraw the whole amount immediately. He is likely to withdraw amounts according to his needs over a period of time). The bank loan is not directly paid to the borrower but is credited to his account. Every bank loan creates an equal deposit in the bank. Thus, credit creation means multiple expansion of bank deposits. The word creation means the ability of the bank to expand deposits as a multiple of its reserves. It is because of the multiple credits creating power of the banks that they have been known as 'factories of credit' or 'manufactures of money'.

In order to understand the commercial banks' process of credit creation, a proper understanding of some basic concepts is essential.

1. Banks are business institutions that aim at maximising profit through advancing loans.

2. Bank deposits

Bank deposits form the basis for credit creation. Bank deposits can be of two types: (1) Primary deposits and (2) Secondary deposits or derivative deposits.

Primary Deposits

When a bank accepts cash from the customer and opens a deposit account in his name, it is called a primary or passive account. These deposits are held as savings accounts, current accounts and fixed deposits and recurring deposits. The creation of primary deposits does not mean the creation of credit. But primary deposits form the basis for the creation of credit. It is out of these primary deposits that the bank grants loans and advances.

Secondary or Derivative Deposits

Whenever a bank grants loans and advances, it opens a deposit account in the customer's name. These are secondary or derivative deposits. The loan amount is not directly given to the borrower. Every loan creates a deposit. It is called a derivative deposit because it has been derived from the loan given by the bank. The creation of

derivative deposits means the creation of credit.

Cash Reserve Ratio (CRR)

Cash reserve ratio is the ratio of deposits that banks have to keep as reserve in the form of cash. The ratio is decided by the Central Bank of a country, in our case, the Reserve Bank of India (RBI). The banks do not need to hold all the deposits as reserves. Banks know that all the depositors will not withdraw all the deposits at the same time. Therefore, they keep a certain percentage of the total deposits for meeting the demand of the depositors and lend out the remaining excess deposits. The percentage of total deposits that the banks are required to hold as a cash reserve for meeting the demand of the depositors is called Cash Reserve Ratio.

Excess Reserve

The reserves that a bank holds over and above the required cash reserves are called excess reserves.

$$Excess\ Reserves\ =\ Total\ Reserves\ (Total\ Deposits)\ -\ Required\ Reserve$$

It is from the excess reserve that loans are given, and credit is created.

Credit Multiplier

The banks can multiply a given amount of cash to many times of credit. In this process of multiple credit creation, the total amount of derivative deposits created by the banks will be a multiple of the initial excess reserves. The ratio between the total amount of derivative deposits and the initial amount of excess reserves is known as the credit multiplier.

For example, if the initial excess reserves of Rs. 1000 produce total derivative deposits of Rs. 5000, then the credit multiplier is 5000/1000= 5.

$$\text{Credit multiplier} = \frac{Total\ derivative\ deposits}{Initial\ excess\ reserves} = \frac{5000}{1000} = 5$$

Credit multiplier is the reciprocal of cash-reserve ratio, i.e., $\frac{1}{r}$, where r stands for cash reserve ratio. Thus, if CRR is 20%, then credit multiplier is 1/20% = 1/0.2 = 5.

In other words,

$$\text{Credit multiplier} = \frac{1}{Cash\ Reserve\ Ratio}$$

2.2.2 Process of Credit Creation by Banks

The process of credit creation can be discussed in two ways viz. when there is only one bank and when there is more than one bank or the banking system as a whole.

Credit Creation by a Single Bank

If there is only one bank in the economy, there can be the chance of multiple expansion of deposits or credits.

Suppose a person P deposits initially Rs 1,000 with the bank. This Rs 1,000 is the primary deposit. By experience the bank knows that all the depositors never approach the bank for withdrawing cash at the same time. The bank will keep a proposition of its deposits in the form of cash for meeting the cash demand of depositors. Suppose the cash reserve ratio is 10 percent. The bank will keep 10% of this primary deposit i.e., Rs 100 as cash reserve and the remaining amount of Rs 900 will be advanced as loan to person Q. The bank will not give cash to Q. The bank will open an account in the name of Q amounting to Rs 900 and allow him to make withdrawals through cheques. Thus, the bank has created a derivative deposit of Rs 900.

To cover this deposit the bank will keep a cash reserve of Rs 90 i.e., 10% of Rs 900 and the remaining amount of Rs 810 (Rs 900 – Rs 90) will be given as loan to another person R. Again, another account of Rs 810 will be opened in the name of person R and cheque book will be issued to him for making withdrawals. Rs 810 is another derivative deposit. Now the bank will again keep a cash reserve of Rs 81 i.e., 10% of Rs 810. The remaining amount of Rs 729 (Rs 810 – Rs 81) will be given as loan to person S. Again, an account will be opened in the name of the person S for Rs 729. This deposit of Rs 729 is another derivative deposit created by the bank. This process will continue. Ultimately, the total amount of primary deposits will accumulate to Rs 1,000 + 900 + 810 + 729 +656.1 +… = Rs 10,000. Total amount of derivative deposits becomes Rs 900 + 810 + 729 + … = Rs 9000. The total amount of cash reserves with the bank becomes Rs 100 + 90 + 81 + 72.90 + 65.61 + … = Rs 1,000 and it will be exactly equal to the initial primary deposit of Rs 1,000. Thus, the commercial bank brings about an increase in total deposits by Rs 10,000 from the initial primary deposits of Rs 1,000 i.e., the total deposits increase by 10 times the initial primary deposit. This process of multiple expansion of credit is shown in the following table

Table 2.2.1 Credit Creation

Person	Primary Deposits (in Rs.)	Cash Reserves r = 10%	Advances (in Rs.)	Derivative Deposits (in Rs.)
P	1000 (Initial Primary Deposit)	100	900	900
Q	900	90	810	810
R	810	81	729	729
S	729	72.9	656.10	656.10

Multiple Credit Creation by the Banking System

In an economic system, there can be a number of banks. Just as a single bank can make multiple expansions of credit, all the banks in the banking system can bring

together multiple expansions of deposits or credits.

Suppose a bank A receives a primary deposit of Rs 1,000. The bank keeps a cash reserve of Rs 100 (i.e., 10% of Rs 1,000) to meet the cash requirement of the depositor. The remaining amount of Rs 900 is advanced as loan to some other customer. It opens an account in the name of that customer and issues a cheque book to enable him to withdraw money. Thus, bank A creates a derivative deposit of Rs 900. The customer deposits this cheque in bank B. Thus, bank B receives a primary deposit of Rs 900. It will keep a cash reserve of Rs 90 (i.e., 10% of Rs 900) and the remaining Rs 810 (i.e., Rs 900 – Rs 90) is given to another person as loan. Thus, bank B creates a derivative deposit of Rs 810. The customer then receives a cheque book from bank B. He deposits his cheque for Rs 810 to another bank C. Thus, bank C receives a primary deposit of Rs 810. This bank keeps a cash reserve of Rs 81 (i.e., 10% of Rs 810) and the remaining Rs 729 is advanced to another person as loan. The bank C opens an account in the name of that customer and issues a cheque book for making withdrawals by him. The cheque for Rs 729 is then deposited by the customer to another bank D. Now the bank D receives a primary deposit of Rs 729. This bank keeps a cash reserve of Rs 72.90 (i.e., 10% of 729) and the remaining amount of Rs 656.10 is advanced as loan to another customer. An account is opened in the name of that customer and a cheque book is issued to him. Thus, bank D created a derivative deposit of Rs 656.10. This process goes on. Ultimately, the total increase in deposits in Bank A amounts to Rs 1,000 + 900 + 810 + 729 + 656.10 + … = Rs 10,000. For Bank B, it starts from 900 + 810 + 729 + 656.10 + ….. , and for C is 810 + 729 + 656.10 + …..

Limitations of Credit Creation by Banks

While banks would prefer an unlimited capacity for creating credit to increase profits, there are many limitations. These limitations make the process of creating credit non-profitable. Therefore, a bank continues to create additional credit as long as:

- There are bad debts i.e., the loans which are not repaid by the borrowers
- The interest rate that banks charge on loans and advances is greater than the interest that the bank gives to depositors for the money deposited in the bank

Hence, we can say that the limitations of credit creation operate through shifts in the balance between liquidity and profitability. The factors that affect the creation of credit are the following:

- The capacity of banks to create credit
- The willingness of the banks to create credit
- The demand for credit in the market
- The capacity to create credit depends on:
- The availability of cash deposits with banks
- The factors which determine their cash deposit ratio

As regards the demand for credit:

- The demand must exist in the market
- Creditworthy borrowers (to avoid bad debts)
- The amount of loan granted should not exceed the paying capacity of the borrower.

2.2.3 Bank Assets

As an individual, all of us have our own assets and liabilities. Individual assets are anything we may own such as a car, a house, or cash in a bank account. Individual liabilities are anything that we have to make payments on such as rent, a mortgage, etc. Just like that, all businesses have their assets and liabilities. Banks also have assets.

2.2.3.1 Balance Sheet

A balance sheet is a financial statement that summarises a company/institution's assets, liabilities, and shareholder's equity at a specific point of time.

The balance sheet of a commercial bank is a statement of its liabilities and assets at a particular point of time. Liabilities refer to all debit items representing the obligations of all the bank or others claims of the bank. On the other hand, assets refer to all credit items representing the bank's claims or its ownership of wealth.

Thus, the balance sheet shows how a bank raises funds and how it invests. It is assumed that the liabilities are mentioned on the left side and the assets on the right side of the balance sheet. A balance sheet of a bank is shown below:

LIABILITIES	ASSETS
1. Share capital	1. Cash- (i) Cash in hand, (ii) Cash with the central bank, and (iii) Cash with another bank
2. Reserve fund	2. Money at call & short notice
3. Deposits- (i) Demand deposits, (ii) Time deposits, and (iii) Saving deposits	3. Bills purchased

4. Borrowing from another bank	4. Investment
5. Acceptance and endorsements	5. Loans and advances
6. Other liabilities.	6. Liabilities of customers for acceptance and endorsement
	7. Building and other fixed assets.

2.2.3.2 Non-Performing Assets (NPA)

We know that in the balance sheet of a bank, loans and advances made by a bank to persons or institutions are assets. This is because these are claims of a bank which should be paid back by the debtor with interest within a specified period of time. But sometimes some of the debtors fail to pay the bank the principal amount and the interest due within the specified time limit. Then a loan which has been regarded as an asset becomes a Non-Performing Asset or a bad debt. The Non-performing Asset has been one of the widespread problems of the financial system. The number of NPAs acts as an indicator of the soundness of the banking system of any country. The problem of NPAs is faced globally but when it comes to developing countries like India, the magnitude is very high.

The banking sector is the keystone to any financial system, and it is important to ensure the smooth working of the banking system to ensure the healthy functioning of any country's economy. Banks create credits in the process of accepting deposit and lending loans and the funds received by the banks from borrowers in the form of interest on loan and repayment of principal are recycled for fund raising. This is the cycle of our banking system which gets disrupted by non-performing assets (NPAs) as it hampers credit growth by affecting the profitability of banks. NPAs work as an indicator to judge banks' performance. The number of NPAs reflects the number of credit defaults of the bank. The increase in NPAs has become one of the most dangerous problems for a commercial bank.

In 1991, the Narasimhan Committee (Committee on financial system reforms, 1991) introduced the concept of the non-performing asset. As per the circular of RBI dated 01-07-2005, NPA is an asset or account of the borrower which has been classified sub-standard, doubtful or loss asset by any bank or financial institution. In simple terms, a non-performing asset is a loan or advance for which the principal amount has not been paid for 90 days. An amount that has not been paid within 30 days from the due date is treated as 'past due'. A loan amount that has not been paid by the borrower is classified as a non-performing asset which becomes an asset that no longer generates income for the bank as the borrower is not paying the interest. In such a situation, the loan is classified as arrears.

The Reserve Bank of India which is the Central Bank of India has defined the non-performing asset as:

An asset that includes leased assets when it stops generating income for the banks or

financial institutions, is termed as NPA. An NPA is a loan or advance in which:

1. Any interest or instalment for which the principal amount is overdue more than 90 days from the due date.

2. The instalment of principal or interest remains due

3. In the case of securitisation transactions, the liquidity amount remains overdue for more than 90 days as per the guidelines of securitisation.

4. For derivative transactions in which the due receivables representing positive mark-to-market value remain unpaid for 90 days from the due date in the case of derivative contracts.

Recap

- Credit means getting the money now by a promise to pay at some time in future.
- The word credit is derived from the Latin word 'credo' which means 'I believe'
- Multiple expansion of deposits by banks is called Credit Creation.
- Banks aim at maximising profit through advancing loans.
- Banks are also known as factories of credit or manufacturers of money.
- When a bank accepts cash from the customer and opens a deposit account in his name, it is called a primary or passive account.
- Whenever a bank grants loans and advances, it opens a deposit account in the borrower's name. These are secondary or derivative deposits.
- The percentage of total deposits that the banks are required to hold as a cash reserve for meeting the demand of the depositors is called Cash Reserve Ratio.
- The reserves that a bank holds over and above the required cash reserves are called excess reserves.
- Excess Reserves = Total Reserves (Total Deposits) - Required Reserve
- The banks can multiply a given amount of cash to many times of credit.

- The ratio between the total amount of derivative deposits and the initial amount of excess reserves is known as the credit multiplier.
- The balance sheet of a commercial bank is a statement of its liabilities and assets at a particular point of time.
- Liabilities refer to all debit items representing the obligations of all the bank or others claims of the bank.
- Assets refer to all credit items representing the banks' claims or their ownership of wealth.
- An asset that includes leased assets when it stops generating income for the banks or financial institutions, is termed as NPA.

Objective Questions

1. What is a Credit?
2. What is Bank Credit?
3. What do you mean by Bank Deposits?
4. Which are the different types of Bank Deposits?
5. What is a Primary Deposit?
6. What is a Secondary Deposit?
7. What is another name for Derivative Deposit?
8. What is CRR?
9. What is Excess Reserve?
10. Mathematically represent Credit Multiplier?
11. What is a balance sheet?
12. Which are the assets of a commercial bank?
13. Which are the liabilities of a commercial bank?

Answers

1. Getting the money now by a promise to pay at some time in future.
2. Bank loans and advances.
3. Bank deposits form the basis for credit creation.
4. Primary deposits and Secondary deposits or derivative deposits.
5. When a bank accepts cash from the customer and opens a deposit account in his name, it is called a primary or passive account.
6. Granting loans and advances
7. Secondary Deposit
8. The percentage of total deposits that the banks are required to hold as a cash reserve
9. The reserve that a bank holds over and above the required cash reserves
10. Credit Multiplier = $\frac{1}{Cash\ Reserve\ Ratio}$
11. A financial statement that summarises a company/institution's assets, liabilities, and shareholder's equity at a specific point of time.
12. Cash, Money at call short-run notice, Bills purchased, Investment, Loans and advances, Liabilities of customers for acceptance and endorsement, Building and other fixed assets.
13. Share capital, Reserve fund, Deposits, Borrowing from another bank, Acceptance and endorsements, other liabilities.

Assignments

1. Distinguish between Primary Deposits and Secondary Deposits.
2. What is a Credit Multiplier?
3. Explain the mechanism of Credit Creation by Commercial Bank and point out the limitations in Credit Creation.

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UNIT 3

Negotiable Instruments

Learning Outcomes

Upon completion of this unit, the learner will be able to:

- familiarise with negotiable instruments
- understand the purpose of negotiable instruments
- distinguish different types of negotiable instruments

Prerequisites

To understand the exact meaning of this first we have to know what is 'credit'? Credit is the privilege to "buy now and pay later". It also means borrowing money now and paying later. Instruments that evidence or acknowledge such credits are called credit instruments. The word 'negotiable' means transferable from one person to another either by mere delivery or by endorsement and delivery, to enable the transferee to get a title in the instrument. An 'Instrument' is "a legally recognised written document, whereby rights are created in favour of one and obligations are created on the part of another". Negotiable Instruments are the most common type of credit instrument used in business. They are written promises or orders to pay money and may be transferred from person to person.

Keywords

Promissory Notes, Bills of Exchange, Demand Draft, Cheque

Discussion

2.3.1 Negotiable Instruments

According to Section 13 of the Negotiable Instruments Act 1881 "a negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer". The Negotiable Instrument Act 1881 mentions only 3 instruments - promissory notes, bills of exchange and cheques but in modern times, many other instruments come under this category. The following are the examples of instruments of credit that are deemed to possess the features of negotiability:

1. Promissory Notes
2. Bills of Exchange
3. Cheques
4. Govt. Securities
5. Dividend Warrants
6. Bank Drafts
7. Share Warrants
8. Hundis

2.3.1.1 Characteristics of Negotiable Instruments

The following are the Important Features of Negotiable Instruments:

1. **Negotiability** - The Negotiable Instruments are easily transferable from person to person; Transferability is an essential feature of a Negotiable Instrument, but all transferable instruments are not Negotiable Instruments. For example, a cheque is a Negotiable Instrument and is transferable, but shares of a limited company are transferable but not negotiable.

2. **Good Title** – A negotiable instrument can be transferred from one person to another. Once the instrument is transferred, the holder obtains a full legal title (ownership) on it.

3. **Legal recourse** – A Negotiable Instrument represents a debt. It implies the right of the creditor to recover something from his debtor. The creditor can either recover this amount himself or can transfer his right to another person. In case he transfers his right, the transferee of a Negotiable Instrument is entitled to sue on the instrument in his name in case of dishonour, without giving notice to the debtor of the fact that he has become the holder.

4. **Presumptions** – There are certain presumptions (beliefs) applicable to all

Negotiable Instruments for example, are considered to have been obtained for consideration. It is not necessary to write in a promissory note the words 'for value received' or similar expressions because the payment of consideration is presumed.

2.3.1.2 Types of Negotiable Instruments

An instrument may possess the characteristics of negotiability either by statutes (by laws) or by usage.

By Statute: - Promissory Note, Bills of Exchange and Cheque are negotiable instruments by statute as they are so recognised by Section 13 of the Negotiable Instruments Act, 1881.

By Usage: - Certain instruments are recognised as negotiable instruments by custom and usage of trade. Banknotes, bank drafts, dividend warrants, share warrants, bearer debentures and treasury bills are some of the examples of these instruments.

1. Promissory Note

Section 4 of the Negotiable Instruments Act, 1881 defines, "A promissory note is an instrument in writing (not being a banknote or a currency note) containing an unconditional undertaking, signed by the maker to pay a certain sum of money to, or to the order of, a certain person or to the bearer of the instruments."

Parties to a Promissory Note

1. The maker: This is the person who makes or executes a promissory note and pays the amount therein.
2. The payee: The person to whom a note is payable is the payee.
3. The holder: A holder is a person who holds the notes. He may be either the payee or some other person.

Essential Characteristics of a Promissory Note

The main features or characteristics of a promissory note are the following:

1. The promise must be to pay a definite sum of money.
2. The promise to pay must be unconditional.
3. There must be an undertaking to pay and not merely an acknowledgement of indebtedness.
4. The promise must be in writing, not verbal.
5. The payee must be a definite person.
6. The instrument must be signed by the maker.

The specimen copy of a promissory note is given below:

₹ 2,000 Kalavoor, Alappuzha

19th April 2011

On demand, I promise to pay Suresh or order the sum of two thousand rupees with interest at 5% per annum for value received.

To

Suresh Stamp

123/4, Alappuzha Sd/- Dev

Fig 2.3.1 Promissory Note

2. Bills of Exchange

A Bill of Exchange is a written acknowledgement of the debt, written by the creditor and accepted by the debtor. Section 5 of the Negotiable Instruments Act 1881 defines the bill of exchange as "an instrument in writing 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 the bearer of the instrument".

Parties to a Bill of Exchange

There are usually three parties to a bill of exchange: Drawer, Acceptor or Drawee, and Payee. Drawer himself may be the payee.

The drawee is the party that pays the sum specified by the bill of exchange. The payee is the one who receives that sum. The drawer is the party that obliges the drawee to pay the payee. The drawer and the payee are the same entity unless the drawer transfers the bill of exchange to a third-party payee.

Essential Characteristics of a Bill of Exchange

The essential characteristics or features of a bill of exchange are similar to a promissory note. They are:

1. The instrument must be in writing.
2. It must be signed by the drawer.
3. The drawer, drawee, and payee must be certain and definite individuals. Sometimes, the drawer and payee may be the same person.
4. It should be properly stamped.
5. It must contain an unconditional order to pay.
6. The sum payable must be certain, and the payment must be in legal tender.

The specimen copy of a bill of exchange is given below:

₹ 2,000 Kalavoor, Alappuzha

19th April 2011

Three months after date pay Suresh or order the sum of one two thousand rupees only for the value received.

To

Devashree Stamp

456/4, Alappuzha Sd/- Dev

Fig 2.3.2 Bills of Exchange

Types of Bills of Exchange

Bills of exchange are used for business and trade transactions within the country and trade across countries. The payment may be immediate or after some time. Thus, bills arising out of such transactions can be classified as:

1. Inland and Foreign Bills
2. Time and Demand Bills
3. Trade and Accommodation Bills

Table 2.3.1 Difference between a Bill of Exchange and a Promissory Note

Criteria For Comparison	Bill of Exchange	Promissory Note
Meaning	Bill of Exchange is an instrument in writing showing the indebtedness of a buyer towards the seller of goods.	A promissory note is a written promise made by the debtor to pay a certain sum of money to the creditor at a future specified date.
Defined in	Section 5 of Negotiable Instrument Act, 1881.	Section 4 of Negotiable Instrument Act, 1881.
Parties	Three parties, i.e., drawer, drawee, and payee.	Two parties, i.e., drawer and payee.
Drawn by	Creditor	Debtor

Liability of Maker	Secondary and Conditional	Primary and Absolute
Can the maker and payee be the same person?	Yes	No
Copies	Bill can be drawn in copies.	Promissory Notes cannot be drawn in copies.
Dishonour	Notice is necessary to be given to all the parties involved.	Notice is not necessary to be given to the maker.

3. Cheque

Section 6 of The Negotiable Instruments Act, 1881, defines a cheque as "a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form".

Parties to a Cheque

The parties to a cheque are:

1. Drawer: Maker of a cheque
2. Drawee: Person directed to pay (the banker in case of a cheque)
3. Payee: Person named in the instrument, to whom or to whose order the money is, by the instrument directed, to be paid.

Features of a Cheque

Important features of a cheque are the following:

- Cheques can be issued against savings or current accounts.
- A cheque is always drawn from a specified banker.
- It is an unconditional order.
- The payee of a cheque is fixed and certain and cannot be changed.
- The payment will only be made in the name of the payee/beneficiary.
- It is an instrument that is payable on demand.
- A cheque will be considered invalid if does not contain the date.

The specimen copy of a cheque is given below:

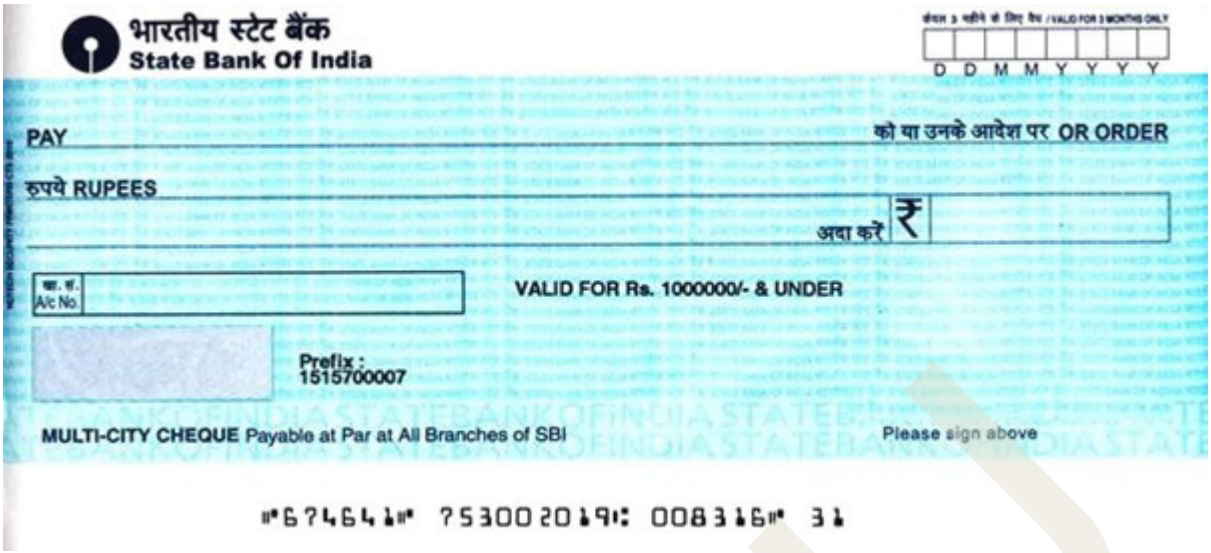

Fig 2.3.3 Cheque

Magnetic Ink Character Recognition (MICR)

Magnetic ink character recognition (MICR) is a technology used primarily to identify and process cheques. The MICR on a cheque is the string of characters that appears at the bottom left of the cheque. It consists of three groups of numbers, including the bank routing number, the account number, and the cheque number.

The MICR includes, from left, a nine-character routing number, a 12-character account number, and a four-character cheque number. It is called a magnetic ink character recognition line about the print technology that is used to enable a machine to read, process, and record information.

Table 2.3.2 Difference between a Cheque and a Bill of Exchange

Criteria for Comparison	Cheque	Bill of Exchange
Meaning	A document used to make easy payments on demand and can be transferred through hand delivery is known as a cheque.	A written document that shows the indebtedness of the debtor towards the creditor.
Defined in	Section 6 of The Negotiable Instrument Act, 1881	Section 5 of The Negotiable Instrument Act, 1881
Validity Period	3 months	Not Applicable
Payable to the bearer on demand	Always	Cannot be made payable on demand as per RBI Act, 1934

Grace Days	Not Applicable, as it is always payable at the time of presentment.	3 days of grace are allowed.
Acceptance	A cheque does not require acceptance.	Bill of exchange needs to be accepted.
Stamping	No such requirement.	Must be stamped.
Crossing	Yes	No
Drawee	Bank	Person or Bank
Noting or protesting	If the cheque is dishonoured, it cannot be noted or protested	If a bill of exchange is dishonoured, it can be noted or protested.

Payment and Collection of Cheques

Payment of Cheques

The banker's primary duty is to repay the money received from his customer's account. The banker should ensure that the instrument presented is a cheque and it satisfies all the conditions of a cheque.

Duties & Rights of The Paying Banker

The banker promises to make payment for customer deposits on demand in accordance with the customer's directions. The promise to repay at the branch of the bank where the account is held and during banking hours. It includes a promise to repay any part of the amount due, against the written order of the customer addressed to the bank at the branch and as such written orders may be outstanding in the ordinary course of business for two or three days. As per the terms of the contract that the bank will not cease to do business with the customer except upon reasonable notice. The customer, on his part, undertakes to exercise reasonable care in executing his written orders, so as not to mislead the bank or to facilitate forgery.

The banker's primary duty is to repay money received for his customer's account, usually by honouring cheques. This obligation has been specifically laid down in Sec 31 of Negotiable Instruments Act 1881, which states "The drawee of a cheque having sufficient funds of the drawer in his hands properly applicable to the payment of such cheque must pay the cheque when duly required so to do, and, in default of such payment, must compensate the drawer for any loss or damage caused by such default."

The paying banker is expected to pay cheques to the genuine payee, after due diligence and as per the mandate and instructions are given by the customer. In case of a default made by the paying banker, he must be responsible and compensate the customer for any loss to him.

Collection of Cheques

One of the most important functions of a modem banker is the collection of cheques

presented by customers drawn upon other bankers. In performing this function, he acts as an agent of his customer.

In the case of collection of cheques, a banker is:

1. A Holder for Value: In the case of uncrossed or open cheques, the person occupies the same position as any other person who so acquires them. The following are some of the situations in which the banker becomes a holder for value:

   a. When the person gives cash in exchange for a cheque drawn on another banker.

   b. When the person credits customer with the amount of cheque as soon as it is paid in and allows to draw at once against the amount; and

   c. When the cheque is expressly paid in to reduce the amount of an overdraft.

2. An Agent: A banker, while collecting a cheque for a customer, cannot assert any right of a holder for value, for the person is acting only as an agent. In doing so, the person gets the same title on the cheque as that of his customer. Thus, a banker who is collecting for a customer a cheque belonging to another person may be held liable for conversion, unless the bank can prove that it acted in good faith and without negligence and that the cheque was crossed before it came into the hands.

Collecting Banker's Duties and Responsibilities

1. It is the duty of the collecting banker to exercise the same care and precaution in the interests of the true owner of a cheque. Failure to obtain references or letters of introduction at the time of the opening of a current account in the name of a person whose title to the cheques collected turned out to be defective was held to amount to negligence sufficient enough to deprive the collecting banker of statutory protection. (Ladbroke and Co. vs. Todd 1914.)

2. Another duty of the collecting banker is to verify endorsements on an order cheque. In the case of an irregular endorsement, he may be held to be guilty of negligence.

3. A banker should make a proper investigation of "Per Pro" endorsements because the collection of such cheques without investigation may amount to negligence on his part. (Brisel & Co. vs. Fox Brothers & Co.).

4. In collecting third party cheques (cheques of which the customer is not the payee but the endorsee), a banker should take extra precautions to safeguard the interests of the true owner.

Precautions To Be Taken by A Collecting Bank

The collecting banks must take some precautions when accepting cheques for collection. They are given below:

i. The collecting banker must undertake to collect cheques of his customers and no one else.

ii. At the time of receipt of cheques for collection, the name on the cheque must

exactly match with the title of the account, for example, cheque with payee name S. Deva can be credited to an account titled S. Deva only and not Deva S.

iii. The date must be valid, and the cheque should not be stale or post-dated.

iv. The amount on the cheque in words and figures must match.

v. All alterations on the cheque must be full and duly authenticated by signing in.

vi. The cheque should be crossed generally.

vii. Cheques with the crossing "Not negotiable" must be examined carefully for the title of parties before accepting for collection.

viii. The endorsements if any on the reverse of the cheque must be regular and must be scrutinised.

ix. Handwriting error or forgery must be taken care of.

x. Cheques that have been returned for financial reasons can be accepted again for collection.

xi. Cheques that have been returned for technical reasons must be accepted only if such technical faults have been addressed.

Dishonour of Cheques

When a cheque is presented to a bank and not paid by the banker, it is called the dishonouring of the cheque. There are two situations in which a cheque can be dishonoured by a banker:

i. Compulsory Dishonour:

In the case of compulsory dishonour, a banker has no choice but to dishonour the cheque. In the following cases the banker has to dishonour a cheque compulsorily:

a. The countermanding (stopping) of payment by the customer.

b. On receipt of a Garnishee order (order of a Court).

c. In case of the death of the customer.

d. In case of insanity of the customer.

e. In case of insolvency of the customer.

ii. Dishonour at the Willingness of the Banker:

A banker may also dishonour a cheque when:

a. it is not properly written.

b. endorsement or crossing is not proper.

c. funds are insufficient in the customer's account.

d. in case of doubt of the right of the holder.

Crossing of Cheques

A crossed cheque is a cheque across the face of which two parallel transverse lines are drawn with or without the words "and Co." or any abbreviation thereof, or some other words, the effect of which is that the banker on whom it is drawn shall not pay the same directly and only through a bank.

A cheque may be crossed generally or specially.

General Crossing

A cheque is crossed generally if it bears two parallel lines without any words or with the words "and Co." or its abbreviation thereof, and with or without the words "Not Negotiable" (Section 123).

By crossing a cheque generally, the banker is directed not to make payment except through another banker and thus a person, who is not entitled to receive its payment, is prevented from getting the cheque cashed at the counter of the paying banker.

Special Crossing

A cheque is crossed specially if it bears across its face two parallel lines and the addition of the name of a banker, either with or without the words "Not Negotiable" (Section 124). A special crossing makes the cheque safer, as a person having no claim will find it difficult to obtain payment except through the banker named in the crossing, who is likely to know the payee, and, therefore, will not collect it for any other person.

A crossing is operative only on a cheque and a postal order. If a bill of exchange other than a cheque is crossed, the crossing is inoperative and the acceptor or party liable can pay the same to any person even though that person is not a banker. When a cheque, as originally issued, is uncrossed, it is permissible for the holder to cross it generally or specially. Where a cheque is crossed specially, the banker to whom it is so crossed may again cross it specially to another banker or his collection agent.

Not Negotiable Crossing

In the case of a cheque crossed generally or specially and bearing, in either case, the words, "Not Negotiable", the position would be that such instrument shall not have, and shall not be capable of giving, a better title to the holder than that which the person from whom it was taken had (Section 130).

The effect of a "Not Negotiable" crossing is to deprive the instrument of the special advantage that a negotiable instrument as such enjoys. The special advantage of a negotiable instrument is that the holder in due course, who receives it for value in good faith, complete and regular on the face of it, and without any notice as to defect in the title of a previous holder, receives it free from all defects in the title of a previous holder.

An instrument crossed "Not Negotiable" may, of course, be endorsed any number of times as far as its transferability is concerned. The effect of adding the words "Not Negotiable" to a cheque is not to impede transfer, but to perpetuate in the hands of any transferee whatever defect or infirmity of title the endorser had who first transferred the

cheque with those words on it.

Who can cross a Cheque?

- *Drawer*

In the first instance, the drawer of a cheque, if he likes, can cross it.

- *Holder*

When a drawer issues an open cheque, any holder of it can cross it generally, convert a general crossing into a special one, or add the words, "Not Negotiable".

- *Banker*

When a cheque is crossed specially, the banker in whose favour it is crossed may again cross it specially to another banker, the latter acting as agent for collection for the former.

- *Cancelling of Crossing*

If a cheque is crossed by the drawer, he has the right to cancel the crossing by writing the words "Pay Cash" across the cheque and by putting down his full signature on the cheque.

- *Loss of Cheque in Transit*

If a bearer, uncrossed or generally crossed cheque is sent by ordinary post at the request of the payee, and the payment of such a cheque is received by a thief, the loss will have to be borne by the payee, on the ground that he employed the post office as his agent. However, according to Section 45 of the Negotiable Instruments Act, the mere sending of a cheque by post does not amount to delivery

4. Demand Draft

A Bank Draft/Demand Draft is an order drawn by an office of a bank upon another office of the same bank or a different bank to pay an amount to the person named in it. A draft is drawn either against cash deposit at the time of its purchase or against debit to the buyer's current or savings account with the bank. These are prepaid instruments that require account holders to pay first, before receiving the bank draft. These instruments are a secure mode of payment since there is no default on their payment.

The important features of a bank draft are:

1. These are drawn by a bank on another branch of the same bank or a different bank.
2. These are prepaid instruments.
3. These will not get returned for financial reasons.
4. These are payable on demand.

5. The payment for such instruments can be stopped only if they get lost or misplaced.

6. They serve as a secured mode of payment.

7. They look and feel the same as cheques but signed by the banker.

Recap

- The negotiable instruments are credit instruments with features of negotiability.
- Instruments that evidence or acknowledge credits are called credit instruments.
- The word 'negotiable' means transferable from one person to another.
- An 'Instrument' is "a legally recognised written document, whereby rights are created in favour of one and obligations are created on the part of another".
- Section 13 of the Negotiable Instruments Act 1881 - "a negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer".
- Examples of Negotiable Instruments are – Promissory Notes, Bills of Exchange, Cheques, Govt. Securities, Dividend Warrants, Bank Drafts, Share Warrants, Hundis
- A promissory note is an instrument in writing containing an unconditional undertaking, signed by the maker to pay a certain sum of money to, or to the order of, a certain person or to the bearer of the instruments."
- The parties to a Promissory Note are -the Maker, the Payee, and the Holder.
- A Bill of Exchange is a written acknowledgement of the debt, written by the creditor and accepted by the debtor.
- The Parties to a Bill of Exchange are – the Drawer, the Acceptor / Drawee, and the Payee.
- The different types of Bills of Exchange are - Inland and Foreign Bills, Time and Demand Bills and Trade and Accommodation Bills
- Section 6 of The Negotiable Instruments Act, 1881, defines a cheque

- Cheque is "a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form".
- The parties to a cheque are – the Drawer, the Drawee, and the Payee.
- Magnetic Ink Character Recognition (MICR) is a technology used primarily to identify and process cheques.
- When a cheque is presented to a bank and not paid by the banker, it is called the dishonour of a cheque.
- A crossed cheque is a cheque across the face of which two parallel transverse lines are drawn with or without the words "and Co." or any abbreviation thereof, or some other words, the effect of which is that the banker on whom it is drawn shall not pay the same otherwise than to a banker.
- A cheque is crossed generally if it bears two parallel lines without any words or with the words "and Co." or its abbreviation thereof, and with or without the words "Not Negotiable" (Section 123).
- A cheque is crossed specially if it bears across its face two parallel lines and the addition of the name of a banker, either with or without the words "Not Negotiable" (Section 124).
- In the case of a cheque crossed generally or specially and bearing, in either case, the words, "Not Negotiable", the position would be that such instrument shall not have, and shall not be capable of giving, a better title to the holder than that which the person from whom it was taken had (Section 130).
- A bank draft/demand draft is an order drawn by an office of a bank upon another office of the same bank or a different bank.

Objective Questions

1. What is a Negotiable Instrument?
2. Which are the important Negotiable Instruments?
3. Who are the Parties to a Promissory Note?
4. What is a Bill of Exchange?
5. Who are the Parties to a Bill of Exchange?
6. What is a DD / Bank Draft?

7. Which section defines Cheque?
8. Who are the Parties to a Cheque?
9. What is Crossing?

Answers

1. A negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer.
2. Promissory Notes, Bills of Exchange, Cheques, Govt. Securities, Dividend Warrants, Bank Drafts, Share Warrants, Hundis are the important Negotiable Instruments.
3. The Maker, the Payee, and the Holder.
4. A Bill of Exchange is a written acknowledgement of the debt, written by the creditor and accepted by the debtor.
5. The Drawer, the Acceptor / Drawee, and the Payee.
6. A bank draft/demand draft is an order drawn by an office of a bank upon another office of the same bank or a different bank.
7. Section 6 of The Negotiable Instruments Act, 1881
8. The Drawer, the Drawee, and the Payee.
9. A crossed cheque is a cheque across the face of which two parallel transverse lines are drawn with or without the words "and Co."

Assignments

1. Write a short note on Bills of Exchange.
2. Explain the features of a Promissory Note.
3. Explain the characteristics of a Cheque.
4. Define a negotiable instrument. Explain the various types of negotiable instruments used in business.

5. What is Crossing? Explain the different types of crossing of cheques.

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Innovative Functions of Banks

Modern Banking

Learning Outcomes

After completing this unit, the learner will be able to:

- understand the concept of modern banking and its evolution
- define e-banking and describe its key features
- explain the concept and advantages of telephone banking
- identify the main features and benefits of internet banking and mobile banking

Prerequisites

Information technology has changed various aspects of our life. The growth and expansion of the internet has revolutionised the banking sector also. Like any other sector, the banking sector is also undergoing a rapid transformation. By using technology, the banks can reduce risks and costs. The main issues faced by banks today are cutting operational costs and managing competition. Technology can help banks in meeting these objectives. Automation is the basic thing that the banks need today. It enables banks to offer 24x7x365 service using less manpower. IT changed the way a bank reaches out to its customers. The Rangarajan Committee Report in the early 1980s was the first step towards computerisation of banks in India. The banks started the idea of total bank automation. The private banks entered the banking industry with different strategies like providing a whole new range of financial products and services at minimal cost. Technology made this possible. Banks started multiple delivery channels such as ATMs, Internet banking, tele banking and mobile banking. This helped in reducing cost per transaction.

Now the world is entered into the NET AGE. The Internet simply means an interconnection of computer networks covering the whole world. The growth of

the internet and IT have facilitated the emergence of E-Commerce. E-Commerce is the paperless exchange of business information spread through computer devices. It refers to carrying on business transactions electronically. It covers any form of business including banking. The future of each bank depends on how well it can leverage the latest innovations to focus on customer needs, wants, satisfaction and behaviour.

Keywords

Modern Banking, E-Banking, Telephone Banking, Internet Banking, Mobile Banking

Discussion

3.1.1 Modern Banking

A bank is a financial institution that accepts deposits and lends money to the public. Banking simply means the business activity of accepting and safeguarding money owned by other individuals and other entities and lending out this money in order to conduct economic activities. Today's banking is virtual banking. It means the provision of banking and other related services through the extensive use of Information Technology (IT). IT has revolutionised various fields of our life. The world has entered the Net Age. In virtual banking there is complete absence of physical bank branches. The various types of virtual banking services include Automated Teller Machines (ATMs), Mobile banking, Internet banking, Electronic Fund Transfer at Point of Sale etc. Due to the adoption of E Banking, the practice of banking has undergone a significant transformation. After demonetisation in 2016, digital banking has grown at a faster pace. Most of the Indian banks have launched their internet banking and mobile banking websites to facilitate the customers with online availability of almost all banking products. Internet banking is now a common mode of secure and convenient banking services.

3.1.2 E-Banking

E-banking or electronic banking refers to all the forms of banking services and transactions performed through electronic means. It allows individuals, institutions, and businesses to access their accounts, transact business, or obtain information on various financial products and services via a public or private network, including the internet.

E-Banking means the conduct of banking electronically. It eliminates the paper-based transactions. There are many differences between conventional or traditional banking and E- Banking. In traditional banking, the customers must visit the bank branches in

person to perform the banking activities such as fund transfer, cash withdrawal etc. E-banking enables the customers to perform these activities by sitting at their homes through PC or laptop. The customers can access the bank's website for viewing their transactions and perform the banking activities. E-banking provides additional delivery channels such as ATM, tele banking, mobile banking, internet banking etc. These are more convenient to customers and cost effective to banks. In traditional banking, the banking services are available only for certain hours. E-banking gives banking services round the clock globally.

3.1.2.1 E-banking Services in India

- **Internet Banking:** It is the type of electronic banking service which enables customers to perform several financial and non-financial transactions via the internet. With internet or online banking or net-banking, customers can transfer funds to another bank account, check account balance, view bank statements, pay utility bills, and much more.

- **Mobile Banking:** This electronic banking system enables customers to perform financial and non-financial transactions via mobile phone. Most of the banks have launched their mobile banking applications available on Google Play Store and Apple App Store. Just like the net-banking portal, customers can use the mobile application to access banking services.

- **ATM:** Automated Teller Machine (ATM) is one of the most popular types of e-banking. ATMs allow customers to withdraw funds, deposit money, change Debit Card PIN, and other banking services. To make use of an ATM, the user must have a password. Banks charge a nominal fee from the customers on every transaction made after crossing the specified limit of free transactions if the transaction is done from any other bank's ATM.

- **Debit Cards:** Almost every person owns a debit card. This card is connected to your bank account, and you can go cashless with this card. You can use your debit card for all types of transactions and the transaction amount is debited from your account instantly.

- **Deposit and Withdrawal:** This service under e-banking offers the customer a facility to approve pay cheques regularly to the account. The customer can give the bank an authority to deduct funds from his/her account to pay bills, instalments of any kind, insurance payments, and many more.

- **Pay by Phone Systems:** This service allows the customer to contact his/her bank to request them for any bill payment or to transfer funds to some other account.

- **Point-of-Sale Transfer Terminals:** This service allows customers to pay for the purchase through a debit/credit card instantly.

3.1.2.2 E-banking Transactions

The following are the type of transactions that can be performed through E-banking:

- Account Enquiry.
- Statement of accounts.
- Fund Transfer.
- Access to interest rates.
- Access to latest schemes.
- Payment of Electricity, water, telephone bills etc.
- Online payment for transactions performed through internet.
- Request for issue of cheque books, drafts etc.

Benefits of digital banking

- Simplified transactions.
- Secrecy of transactions.
- Transactions without intervention of bank staff.
- Convenience of banking anywhere and anytime.
- Innovative products and services offered by banks.
- No trips to branches.
- Better profitability by reducing dependence on physical branch network.
- Achieving businesses targets and reach in a highly cost-effective manner.
- No queues leading to time saving.
- More customer loyalty by offering personalised offers and services at the convenience of customers.
- More business by offering customer specific products.
- 360-degree view of customers by collecting data from banks records, social media, and other public domains.
- Operational efficiency by maintaining accurate data and reliable management information system.

Banking is now in the pocket of the customer. Still, it is just the beginning, and the exciting digital journey will continue in coming years.

3.1.3 Telephone Banking

Telephone banking is a facility enabling customers to make use of banking services, such as oral payment instructions, account movements, raising loans, etc, over the

telephone rather than by personal visit.

Telephone banking is a service provided by a bank or other financial institution, that enables customers to perform over the telephone a range of financial transactions which do not involve cash or financial instruments without the need to visit a bank branch or ATM.

Telephone banking became commercially available in the 1980s, first introduced by Giro bank in the United Kingdom, which established telephone banking service in 1984. Telephone banking saw growth during the 1980s and early 1990s. The development of online banking in the early 2000s resulted in a decline in the use of telephone banking. The advent of mobile banking reduced the use of telephone banking in the 2010s.

Telephone Banking Features

- Obtain real-time account balances and detailed transaction history
- Verify direct deposits
- Verify cheque and deposit transactions
- Verify interest information
- Request a statement fax
- Reorder cheques
- Rate and general information
- Loan payment information
- Transfer money between eligible accounts
- Make loan payments
- History and tax information
- Activate debit cards
- Request to stop payment
- Report a lost or stolen debit/ATM card
- Get answers to frequently asked questions
- Check locations and hours of operations

Advantages of Telephone Banking

Tele Banking is a medium to sell a range of banking products and services to its customers. Fast, safest, and convenient banking service, offered by the banks. Enables its customers to get instant feedback regarding their account while staying at their home or office. Reduces transaction handling cost.

It is convenient because you can pay your bills on time and do not have to go to the utility company during business hours. It saves time as it eliminates waiting in line at the utility company. It is safer because you do not have to walk around with cash to pay your utility bills.

Disadvantages of Tele Banking

First-time users may find the system difficult to use. Instead of a receipt, you will receive a transaction reference number as proof that the payment was made.

There are also some potential security risks that arise through the use and development of telephone banking systems. Since customers are not actually present and face-to-face with a bank teller or manager, it may be easier for identity theft to occur and produce misrepresentation of customer needs over the telephone. This can be controlled through various security protocols incorporated into a phone banking system, but even these measures can be insufficient in some instances.

3.1.4 Internet Banking

Internet banking, also known as online banking, e-banking or virtual banking, is an electronic payment system that enables customers of a bank or other financial institution to conduct a range of financial transactions through the financial institution's website. The biggest difference between internet banking and mobile banking is in their functionality. Internet banking allows you to conduct online transactions through your PC or laptop and an internet connection. On the other hand, mobile banking can be done with or without the internet. This service gives online access to almost every banking service, traditionally available through a local branch including fund transfers, deposits, and online bill payments to the customers. Customers need not visit their bank's branch office to avail these services. All account holders may not get access to internet banking. If you would like to use internet banking services, you must register for the facility while opening the account or later. You must use the registered customer ID and password to log into your internet banking account. Let us discuss the features of Internet Banking.

- Check the account statement online
- Open a fixed deposit account
- Pay utility bills such as water bill and electricity bill
- Make merchant payments
- Transfer funds
- Order for a cheque book
- Buy general insurance
- Recharge prepaid mobile/ (Direct to Home) DTH

- Provides access to financial as well as non-financial banking services
- Facility to check bank balance any time
- Make bill payments and fund transfer to other accounts
- Keep a check on mortgages, loans, savings accounts linked to the bank account
- Safe and secure mode of banking
- Protected with unique ID and password
- Customers can apply for the issuance of a chequebook
- Keep a check on investments linked to the bank account

Internet banking has become a necessity to individuals transferring funds. Today, more and more customers are using net banking for sending and receiving payments. The funds transferred through the Electronic Fund Transfer (EFT) system are not only secure and safe but also reach the concerned party in the shortest possible time, within 24 to 48 hours. The net banking users are required to submit certain facts and IFS Code of the beneficiary bank branch to complete the fund transfer transaction smoothly.

3.1.4.1 The Advantages of Internet Banking

- **24×7 Availability**: You can avail the banking services round the clock throughout the year. Most of the services offered are not time-restricted; you can check your account balance at any time and transfer funds without having to wait for the bank to open.
- **Easy to Operate:** Online banking is simple and easy. Many find transacting online much easier than visiting the branch for the same.
- **Convenience:** Internet banking is largely preferred because of the convenience that it provides while doing fund transfer and bill payments. Registered users can use almost all the banking services without having to visit the bank and standing in queues. Financial transactions such as paying bills and transferring funds between accounts can easily be performed anytime as per the convenience of the user.
- **Activity Tracking:** When you make a transaction at the bank branch, you will receive an acknowledgement receipt. There are possibilities of you losing it. In contrast, all the transactions you perform on a bank's internet banking portal will be recorded. You can show this as proof of the transaction if needed. Details such as the payee's name, bank account number, the amount paid, the date and time of payment will be recorded.
- **Quick and Secure**: You can complete any transaction in a matter of a few minutes via internet banking. You can transfer funds to any account within the country or open a fixed deposit account within no time through net banking.

- Banking users can transfer funds between accounts instantly, especially if the two accounts are held at the same bank. Funds can be transferred via NEFT, RTGS or IMPS as per the user's convenience. One can also make bill payments, EMI payments, loan, and tax payments easily. Moreover, the transactions, as well as the accounts, are secured with a password and unique User-ID.

- **Non-financial Services**: Besides fund transfer, internet banking allows the users to avail non-financial services such as balance check, account statement check, application for issuance of cheque book, etc.

- The safety procedures applied by the banks and supervision of the Reserve Bank of India over banks ensures your accounts safety.

- The banks also use the net banking services to promote their products and services among the users.

3.1.4.2 Disadvantages of Internet/Online Banking

The disadvantages of internet banking are as follows:

- **Internet Requirement:** A computer/laptop and Broadband connection are a must for net banking, because without internet connection, one cannot access his/her account. An uninterrupted internet connection is a foremost requirement to use internet banking services. If you do not have access to the internet, you cannot make use of any facilities offered online. Similarly, if the bank servers are down due to any technical issues you cannot access net banking services.

- **Transaction Security:** Security of account is a critical issue because there are chances of your account and transaction information getting hacked. No matter how much precautions banks take to provide a secure network, online banking transactions are still under the threat of hacking. Irrespective of the advanced encryption methods used to keep user data safe, there have been cases where the transaction data is hacked. This may cause a major threat such as using the data illegally for the hacker's benefit.

- **Difficult for Beginners:** There are people in India who have been living lives far away from the web of the internet. It might seem a whole new deal for them to understand how internet banking works. Not everybody is proficient in using the Internet. New users may find it difficult to use net banking.

- **Securing Password:** Every internet banking account requires the password to be entered to access the services. Therefore, the password plays a key role in internet banking. If the password is revealed to others, they may utilise the information to devise some fraud. Also, the chosen password must comply with the rules stated by the banks. Individuals must change the password frequently to avoid password theft which can be a hassle to remember for the account holder himself. The knowledge of your Password to any third person may result in hacking your account and drawing funds from your account.

- If the server is down, or there is no internet connectivity, online transactions will fail, or you will not find out if your transaction is successful or not.

The advantages and disadvantages of net banking clearly shows that if you take certain precautionary measures such as keeping your password safe, changing it from time to time, hiding it or memorising it without leaving any visible password record can be the best solution for safe and secure online bank transactions.

3.1.5 Mobile Banking

Mobile banking is a facility that enables customers to perform banking tasks on their mobile phones. This is provided by most of the banks in India and abroad. Customers can use mobile banking to view their account balance, make instant fund transfers and pay bills, etc.

There are various types of mobile banking, viz. via SMS, USSD and mobile apps. Some of the banks like SBI, have incorporated services like loan approval and linking of insurance policy in their mobile banking apps.

Mobile banking is very convenient in today's digital age with many banks offering good apps. The ability to deposit a cheque, to pay for merchandise, to transfer money to a friend or to find an ATM instantly are reasons why people choose to use mobile banking.

Cybersecurity has become increasingly important in many mobile banking operations. Cybersecurity encompasses a wide range of measures taken to keep electronic information private and avoiding damage or theft.

Three main types of cyber-attacks can occur. These are:

- Backdoor attacks, in which thieves exploit alternate methods of accessing a system that does not require the usual means of authentication.
- Denial-of-service attacks prevent the rightful user from accessing the system. For example, thieves might enter a wrong password a number of times so that the account is locked.
- The direct-access attack includes bugs and viruses, which gain access to a system and copy its information.

3.1.5.1 Mobile Banking Services

Mobile banking is one step closer to creating a completely digitalised environment. It lessens paperwork and avoids waiting time which is otherwise wasted in long queues.

Banks provide mobile banking services to their clients in different ways, Such as

- Mobile Banking over mobile applications for smartphones, e.g., SBI YONO and iMobile by ICICI Bank, etc.

- Mobile Banking over SMS (also known as SMS Banking)
- Mobile Banking over Unstructured Supplementary Service Data (USSD)

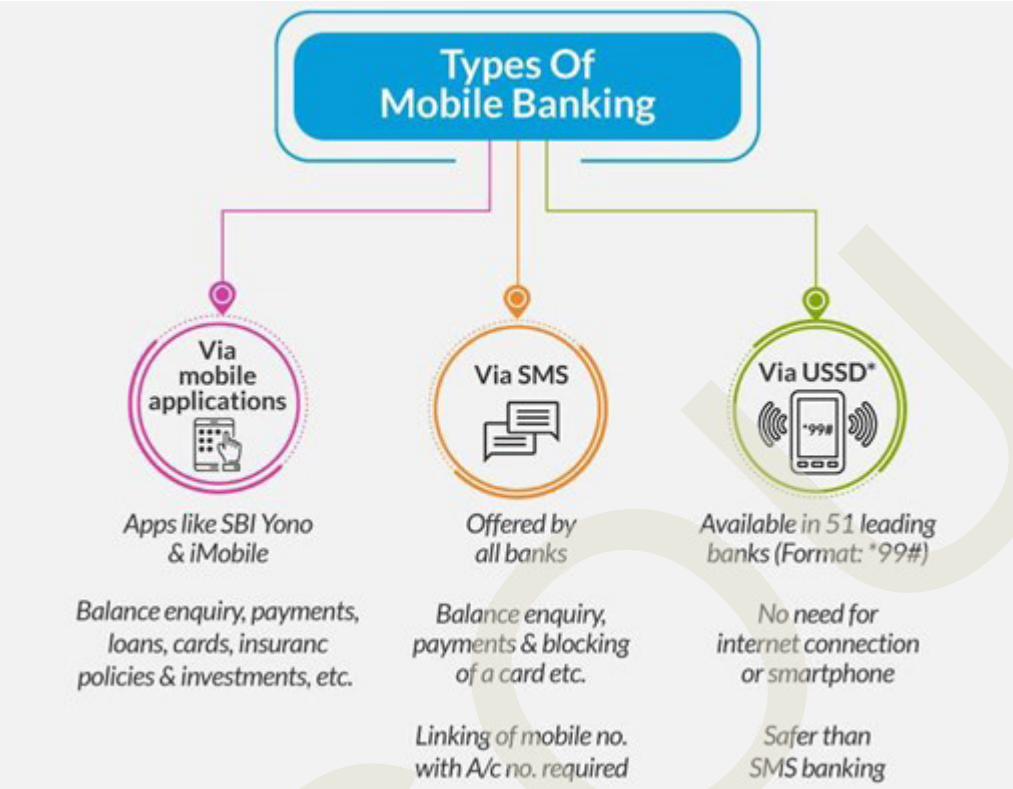

Fig 3.1.1 Types of Mobile Banking

Mobile banking is useful to customers in the following ways:

1. Access to Account Information

Knowing your exact bank balance is important. This helps you in better management of your funds. And thus, this is the primary mobile banking service provided by any bank. You can check the following:

- View account balance (Balance enquiry)
- Transaction history
- E-statement of account
- Loan statements
- Card statements
- e-Passbooks

2. Transactions

Making payments and transferring money from one account to another is the most basic banking activity. You can transfer funds to anyone by adding them as beneficiaries

or simply via Unified Payments Interface or UPI.

- Bank to bank transfers
- Transfer of funds to self
- Payments to third parties (rent payments, bill payment, etc.)
- Giving standing instructions for periodic payments
- Payments via NEFT/IMPS/RTGS/UPI/MMID

3. Investments

- Opening fixed deposit/recurring deposits
- Mutual fund investments
- Portfolio management services (e.g., SBI Capital Securities)

4. Other Services

Apart from the account summary, bill payments, fund transfers and investments, there are other services that a customer requires for smooth banking experience. Also, there may be times when you have some grievances and due to lack of time, are not able to address them. For such extra services, you can always resort to your bank's mobile banking and find solutions to your complaints or queries. These services include:

- ATM locators
- Branch locators
- Lodging complaint/ tracking applications
- Ordering new cheque book
- Cancelling/stopping an issued cheque

Mobile Banking over SMS

Along with mobile apps, most banks offer mobile banking services over SMS. This service is useful for those who do not have smartphones or internet connection. Customers need to register their mobile number with their bank to avail SMS banking.

Services Offered by SMS Banking

- Balance Enquiry
- Get mini statement
- Transfer of funds to/from self-accounts (e.g., savings account to current account)
- Block ATM card or a credit card

- Enquiry for forex rates
- Enquiring about current interest rates (e.g., Fixed deposit rates and savings rates)

These services are carried out by push/pull messages. Push messages mean when the bank initiates a communication, often reminding about payment or notification about a withdrawal. OTP or One-Time Password is also a type of push message.

Pull messages are those messages that are initiated by the customer. These can be for account balance enquiry and for cancelling an issued cheque, etc.

For instance, to check the available balance in their account, they may have to send an SMS in the format: AVAIL BAL XXXX where XXXX is the last 4 digits of the account number. The bank replies with an SMS with the current available balance in the account.

Mobile Banking over USSD

USSD or Unstructured Supplementary Service Data is a type of communication via which one can exercise basic banking services. There is no need for a smartphone or an internet connection for this service. It allows services like balance enquiry and transfer of funds.

*99# – a USSD based mobile banking service, has been launched by National Payment Corporation of India (NPCI) which is supported in 51 leading banks in India.

There are some measures that you must take when doing mobile banking or online banking. These are:

1. **Use a safe network connection** – It is important that you do not use any public Wi-Fi or someone else's device for online banking. If you have to use a public network, set up a Virtual Private Network (VPN) software and only then go ahead.
2. **Licensed anti-virus** – Make sure you have anti-virus software installed in your device for an added layer of protection. Also, this should be a licensed software for which you will receive a key when you buy it. Without this key, nobody can make any changes in the software. This provides foolproof protection.
3. **Subscribe for push message notification** – Doing this ensures that you are always informed about any transaction that takes place to/from your account. Also, if there are any unsuccessful login attempts to your internet banking account, your bank will send you a notification. In such cases, you can contact your bank and get your account secured.
4. **Avoid signing in via a third-party website or promotional emails** – Never click on URLs received in an SMS or promotional email. Also, avoid using third-party websites to sign into your account. This can be extremely harmful.

Advantages of Mobile Banking

- Time Saving. Mobile Banking offers quick and instant banking services.

- Remote Banking is possible
- Monitoring Transactions.
- Easy Access
- Round-the-clock availability
- Value-Added Services

Disadvantages of Mobile Banking

- Technical knowledge is needed
- Mobile app fraudulent transactions have been increasing
- Digital fraud losses are the direct result of takeovers of the accounts.
- About one in every 20 fraud attacks are associated with a mobile banking app.

Recap

- Modern banking revolutionises banking services with IT advancements
- E-banking refers to banking services and transactions performed through electronic means
- Telephone banking enables customers to access banking services over the phone
- Internet banking allows customers to perform financial and non-financial transactions online
- Mobile banking enables customers to perform banking tasks using their mobile phones

Objective Questions

1. What is E-Banking?
2. What is Internet Banking?
3. What is Mobile banking?
4. Which are the services provided by Mobile Banking?

5. Write any two advantages of Mobile Banking?

6. What any two disadvantages of Mobile Banking?

7. What do you mean by Telephone banking?

Answers

1. E-Banking means the conduct of banking electronically. It eliminates the paper-based transactions.

2. Internet banking, also known as online banking, e-banking or virtual banking, is an electronic payment system that enables customers of a bank or other financial institution to conduct a range of financial transactions through the financial institution's website.

3. Mobile banking is a facility that enables customers to perform banking tasks on their mobile phones

4. Banks provide mobile banking services to their clients in different ways, such as:

   - Mobile Banking over mobile applications for smartphones, e.g., SBI YONO and iMobile by ICICI Bank, etc.
   - Mobile Banking over SMS (also known as SMS Banking)
   - Mobile Banking over Unstructured Supplementary Service Data (USSD)

5. Advantages are as follows;

   - Time Saving. Mobile Banking offers quick and instant banking services.
   - Remote Banking is possible

6. Disadvantages are as follows;

   - Technical knowledge is needed
   - Mobile app fraudulent transactions have been increasing

7. Telephone banking is a facility enabling customers to make use of banking services, such as oral payment instructions, account movements, raising loans, etc, over the telephone.

Assignments

1. What is E-banking? Explain the advantages and disadvantages of E-banking.
2. Explain the features of internet or digital banking.
3. Briefly explain the pros and cons of online banking.
4. What are the advantages and disadvantages of mobile banking?
5. Describe the features of Telephone Banking.

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UNIT

Types Of Cards

Learning Outcomes

After completing this unit, the learner will be able to:

- know the different types of cards used in banking
- identify the features of credit and debit cards
- learn about the purpose and benefits of the Kisan Credit Card
- recognise the functionalities of smart cards in banking

Prerequisites

Bank cards form part of the daily lives of hundreds of millions of people. The keys to their success are their comfort and simplicity for carrying out all kinds of operations like cash withdrawals, purchases, payments etc. Payment Cards are an essential part of the payment system set up by banking institutions that offer hassle free and cash free options to make payments and withdraw money as per the need of the card holder. Some of the most common types of cards used in the banking system are debit cards, credit cards, prepaid cards, and Forex cards. Types of payment cards and the difference among cards used in the banking system is a basic topic of banking awareness and general knowledge that you should know about and here we are going to discuss the same in detail.

The COVID-19 pandemic's effects on the financial sector and consumers have been known to all. Banking may never be the same moving forward, in many ways. That could also include disappearance of cash, a mode of payment that was already on the decline. It is important to know what types exist and their differences in order to make the best decisions and take care of your financial health.

Types of payment cards and the difference among cards used in the banking system is a basic topic of banking awareness and general knowledge that you should know about and here we are going to discuss the same in detail.

Keywords

Credit Card, Debit Card, Kisan Credit Card, Smart Card

Discussion

3.2.1 Types of Cards used in Banking System

The banking system offers a variety of cards tailored to meet different financial needs and purposes. Here are the most common types of cards used in the banking system, along with their features and differences.

Table 3.2.1 Types of Cards

Card	Features
Debit Card	Make payments from linked account
Credit Card	Used to borrow money and make payments
Forex Card	To hold foreign currency during international travels
Prepaid Cards	Load the money in advance and then make transaction

3.2.2 Credit Cards

Credit cards allow the user to borrow money from the bank and make purchases. Banks or companies issuing the credit card creates a revolving account and grants a line of credit to the cardholder, and then the user borrows money for payments or can also withdraw cash at times. Companies issuing credit cards also set a minimum repayment amount for the amount borrowed and also charge interest on delayed payments.

These cards are instruments that allow you to defer a payment when making a purchase, to finance specific operations, or to have money to cover your expenses within a certain time and credit limit. This is the main difference with respect to a debit card, in which the operations are automatically deducted from the available balance. In the case of credit cards, it is not necessary that the amount be available at the time of purchase.

Credit cards allow you to pay a given amount of money in two ways. You can choose the total payment without interest option so that all purchases made with the card are deferred or you can choose the deferred payment option, or postponement of a specific purchase, which consists in paying back the amount of money agreed upon in several instalments with interest.

In this case, you can choose a fixed fee to pay each month or, in the case of postponing a certain purchase, set a deadline to return the entire amount. Deferred payment method is like the bank is giving you a small loan that must be repaid.

Since it is a financial product, banks usually ask for a series of requirements before granting a credit card. By considering the client's profile, the bank will accept or deny its concession based on the risk criteria.

3.2.2.1 Eligibility Requirements to get a Credit Card In India

- Applicant must have a minimum age of 18 years
- The minimum income salary must be between Rs.1 lakh and Rs.3 lakh.
- Applicant should either be salaried or self-employed

Introducing a credit card in your wallet can be financially liberating. With pre-approved credit limits, 40-50 days of interest free credit and value-added benefits on transactions such as cashbacks, rewards etc., there are multifarious perks of owning a credit card. India's 1.3 billion population is supported by a mere 63.5 million cards in force (CIF), as compared with 1.1 billion CIF for the 320 million Americans. In other words, for 2000 Indians we have 1 credit card, whereas for every 2,000 Americans there are seven. Your credit history and repayment capacity are the two most important factors that determine your eligibility for a credit card. The card issuing bank will assess your creditworthiness prior to extending a credit facility.

The bank would typically look for the following parameters:

- Indian National, with a valid residence proof.
- Credit score of at least 700, and a minimum six months of regular credit history.
- Minimum income of INR 20,000 per month.
- Minimum age of 21.
- Your current income and credit utilisation behaviour.

Fresh applicants facing a challenge with the above attributes can initially opt for secured cards i.e., a card issued against a fixed deposit for 80% value of the bank deposit. A secured credit card is one of the surest ways for first timers with low or an unverifiable income. Those with red flags in their credit report can also avail a secured credit card and gradually build their credit history, and then graduate to traditional credit cards i.e., unsecured credit facility.

Credit cards can be loosely categorised as:

- Travel Cards
- Lifestyle and Entertainment Cards
- Online Spends
- Shopping Cards

Documents Required for a Credit Card Application

- Completed application form.
- Passport-size photographs.
- Proof of identity (copy of PAN, Aadhaar, Passport, etc.)
- Proof of residence (utility bills, Driving Licence, PAN, Aadhaar, etc.)
- Latest salary slips.
- Form 16.
- Bank statements.

3.2.2.2 Advantages of Credit Cards

1. Easy Access to Credit

The biggest advantage of a credit card is its easy access to credit. Credit cards function on a deferred payment basis, which means you get to use your card now and pay for your purchases later. The money used does not go out of your account, thus not denting your bank balance every time you swipe.

2. Building a Line of Credit

Credit cards offer you the chance to build up a line of credit. This is very important as it allows banks to view an active credit history, based on your card repayments and card usage. Banks and financial institutions often look at credit card usage to gauge a potential loan applicant's creditworthiness, making your credit card important for future loans or rental applications.

3. EMI Facility

If you plan on making a large purchase and do not want to sink your savings into it, you can choose to put it on your credit card as a way to defer payment. In addition to this, you can also choose to pay off your purchase in equated monthly instalments, ensuring you are not paying a lump sum for it and denting your bank balance. Paying through EMI is cheaper than taking out a personal loan to pay for a purchase, such as a television or an expensive refrigerator.

4. Incentives and Offers

Most credit cards come packed with offers and incentives to use your card. These

range from cash back to rewards point accumulation each time you swipe your card, which can later be redeemed as air miles or used towards paying your outstanding card dues. Lenders also offer discounts on purchases made through a credit card, such as on flight tickets, holidays, or large purchases, helping you save.

5. Flexible Credit

Credit cards come with an interest-free period, which is a period of time during which your outstanding credit is not charged interest. Ranging between 45-60 days, you can avail free, short-term credit if you pay off the entire balance due by your credit card bill payment date. Thus, you can benefit from a credit advance without having to pay the charges associated with having an outstanding balance on your credit card.

6. Record of Expenses

A credit card records each purchase made through the card, with a detailed list sent with your monthly credit card statement. This can be used to determine and track your spending and purchases, which could be useful when chalking out a budget or for tax purposes. Lenders also provide instant alerts each time you swipe your card, detailing the amount of credit still available as well as the current outstanding on your card.

7. Purchase Protection

Credit cards offer additional protection in the form of insurance for card purchases that might be lost, damaged or stolen. The credit card statement can be used to vouch for the veracity of a claim if you wish to file one.

3.2.2.3 Disadvantages of Credit Cards

1. Minimum due Trap

The biggest con of a credit card is the minimum due amount that is displayed at the top of a bill statement. A number of credit card holders are deceived into thinking the minimum amount is the total due they are obliged to pay, when in fact it is the least amount that the company expects you to pay to continue receiving credit facilities.

This results in customers assuming their bill is low and spending even more, accruing interest on their outstanding, which could build up to a large and unmanageable sum over time.

2. Hidden Costs

Credit cards appear to be simple and straightforward at the outset but have a number of hidden charges that could rack up the expenses overall. Credit cards have a number of taxes and fees, such as late payment fees, joining fees, renewal fees and processing fees. Missing a card payment could result in a penalty and repeated late payments could even result in the reduction of your credit limit, which would have a negative impact on your credit score and future credit prospects.

3. Easy to Overuse

With revolving credit, since your bank balance stays the same, it might be tempting to put all your purchases on your card, making you unaware of how much you owe. This could lead to you overspending and owing more than you can pay back, beginning

the cycle of debt and high interest rates on your future payments.

4. High Interest Rate

If you do not clear your dues by your billing due date, the amount is carried forward and interest is charged on it. This interest is accrued over a period of time on purchases that are made after the interest-free period. Credit card interest rates are quite high, with the average rate being 3% per month, which would amount to 36% per annum.

5. Credit Card Fraud

Though not very common, there are chances you might be a victim of credit card fraud. With advances in technology, it is possible to clone a card and gain access to confidential information through which another individual or entity can make purchases on your card. Check your statements carefully for purchases that look suspicious and inform the bank immediately if you suspect card fraud. Banks usually waive off charges if the fraud is proven, so you will not have to pay for purchases charged by the thief.

3.2.3 Debit Card

These are the most common type of bank cards and the simplest to use. They are associated with a bank account and allow you to pay in both physical and online stores and to withdraw cash at branches or Automated Teller Machines (ATMs).

The amount of the transaction is automatically deducted from the available balance. Therefore, if there was not enough money in the account, the transaction could not be carried out. For security reasons, the debit card usually has a daily limit associated with it, especially when withdrawing funds from an ATM.

They allow the card holder to transfer money electronically from their bank accounts and can also be used as ATM cards to withdraw cash using the Automated Teller Machine.

Fig 3.2.1 Debit Card

A debit card is linked to your bank account. There is no possibility of making any transaction on credit. All transactions and withdrawals are limited to the balance available in your account.

Debit cards are also known as cheque cards. Debit cards look like credit cards or

ATM cards but operate like cash or a personal cheque. Debit cards are accepted at many locations including grocery stores, retail stores, gasoline stations and restaurants. One can use his/her card anywhere. It is an alternative to carrying a cheque book or cash. There is a major difference between credit cards and debit cards. A credit card is a way to 'Pay later' while a debit card is a way to 'pay now'.

When one uses a debit card, his/her money is quickly deducted from his/ her savings account. Debit cards allow one to spend only what is in her/his bank account. It is a quick transaction between the merchant and one's personal bank account. Obtaining a debit card is often easier than obtaining a credit card.

Commonly Used Debit Cards In India

- Visa debit cards
- MasterCard debit cards
- RuPay debit cards
- Contactless debit cards
- Maestro Debit Card

Both Visa and MasterCard debit cards have similar functionality and both of them are foreign payment gateway that provides payment facility to most of the banks in the world. They can also be used to make payments in other countries as well. An important thing to note is that they do not provide any actual credit to any party, they are just payment methods and rely on various banks to issue cards using these payment methods. Maestro is the name given to a brand of MasterCard.

Visa Electron debit cards do not offer the overdraft feature that Visa debit cards do. One of the main advantages of this card is that the card holder will never be allowed to overspend or will not fall into debt and no interest charges are there for cash withdrawal. Contactless debit cards have built-in radio frequency modules which can facilitate the card holder to make payments by simply waving the card over a supported machine.

Most of the cards now come with this technology of an integrated chip that adds a layer of security. One such card is EMV Chip Card - EMV stands for Europay MasterCard and Visa and EMV Cards are essential smart payment cards also known as IC cards. They prevent cloning of the card.

RuPay is an Indian Domestic Payment system created by the National Payments Corporation of India. As per the official website rupay.in, it was conceived to fulfil RBI's vision to offer a domestic, open-loop, multilateral system which will allow all Indian banks and financial institutions in India to participate in electronic payments. It is made in India, for every Indian to take them towards a 'less cash' society. Banks are required to pay a quarterly fee for visa, master, or foreign payment facilities whereas RuPay network is free of charge and is used only in India. Deferred Debit Card allows the facility of payment being done a few days later from the date of purchase.

Debit card acts as a type of prepaid card. It is so since it already has a sufficient amount of cash balance in its holder's bank account. It permits the holder to carry on the value of the transaction (i.e., purchases) to the extent of available balance in its holder's bank account.

Banks issuing a debit card charge an annual fee for the issuance and maintenance of the card. The fee charged is very nominal in nature. Generally, a bank charges the fee on a per annum or yearly basis. Such a fee gets automatically debited (deducted) from the debit-cardholder's bank account.

Debit cards act as an alternative mode of payment for executing various cash-related financial transactions. It can be used for the purchases of goods and receipt of services. In its presence, there is no need to carry a large amount of cash. Thus, it helps to avoid carrying huge amounts of cash while travelling and minimises risk of loss due to theft, damage, etc.

Debit card ensures immediate transfer of funds in the merchant's or dealer's bank account. Such a transfer of funds takes place almost instantly at the moment of purchases of goods and receipts of services. With its use, there is no need to visit a bank's office premise and do a manual transfer of cash in the merchant's or dealer's bank account. Thus, it saves precious time and gives ease, safety, and comfort to its holder in his or her finance related activities.

The debit card facilitates instant withdrawal of cash from any nearest ATM. This helps its holder to avoid a personal visit to the bank's office premise and waiting in a long-time consuming queue. In short, it also acts as an ATM card to meet its holder's cash-related needs, anytime and anywhere.

Debit cards are very easy to carry, handle and manage while traveling to outstations or overseas. Being small, thin, flat, and having a negligible weight, it easily fits in any pocket. It can be handled very freely even with just two fingers. Managing it is also not a big problem.

3.2.3.1 Advantages of Debit Card

- For those holding debit cards, there is no requirement to carry physical cash, which is quite a secure measure of making transactions. There is no possibility of your money getting lost or stolen in this way.
- Using a debit card at POS terminals will result in faster transactions and reduce your time in a queue.
- When using a debit card, one can spend only up to how much he/she has in their bank account and not more. There is no paying back system and interest over the money borrowed and so on.
- Customers are offered a debit card when opening a bank account. In most cases, the fee is waived for the first year of holding the card.
- A customer holding a debit card can use whatever is in the bank account of the individual

- Now, for high-valued transactions, customers can break the amount to be paid in EMIs - just as one can do with a credit card.
- If there is a requirement for cash, one can make a withdrawal from any bank ATM across the country and it is completely free for withdrawals from the same bank ATM. For withdrawals from other bank ATMs, the debit card holder is granted 3-5 free withdrawals in a month.
- With every purchase made using one's debit card, the card holder will earn points that can be redeemed in the form of movie tickets, travel tickets, discounts and so on.
- For certain cards, customers are offered fuel cashbacks, dining discounts, travel discounts and so on.
- Debit cards act as an alternative to a traditional cheque payment.
- It helps to budget one's expenses and do a responsible spending of own money within account limits.
- Its holder uses his own money and not any borrowed (loaned) money. Unlike a credit card, here, no interest is charged. Hence, its transactions are interest free.
- It is accepted internationally, by e-commerce websites, and almost everywhere by merchants who display the logo of payment processing companies like VISA, Master Card, American Express, etc. This ensures making successful payments anywhere in the world with ease.
- It offers optimum levels of security. This greatly minimises the chances of fraud, misuse, and theft of money.
- Overall, it enhances the banking experience of a cardholder

3.2.3.2 Disadvantages of Debit Cards

Debit card holders might face the following disadvantages.

- If by chance you are charged for a transaction, but it does not happen - either a recharge or payment of bills or to purchase a product online - it will be a difficult process to get a reimbursement.
- Using your debit card at other bank ATMs will be chargeable after a certain number of withdrawals. The charge in most cases is quite steep.
- In some cases, redeeming the reward points might prove to be quite a hassle and, in most cases, the third-party site where one can redeem the points won't work.
- Debit card transactions have no effect on one's credit score unlike credit card transactions. To avail any type of loans, customers need to avail a formidable

credit score - anything above 750, and debit cards do not have anything to do with this regard.

- Fraudulent techniques such as skimming, phishing, SIM swap and so on have put debit cards at risk and have questioned its security. Now, if a fraudster manages to duplicate the details of the debit card, in most cases, the money might be stolen forever. Approaching the bank to investigate the case and getting a reimbursement or an insurance coverage for it will certainly be quite a difficult task. The biggest drawback being that if one's card details have been duplicated, the entire money in one's account is susceptible to fraud. On the other hand, if it happens that the money in your credit card is stolen, then only the money that has been loaded on the card is susceptible to fraud. And if it does get stolen, then since it is the bank's money, the bank will do everything to get the money back and investigate the case. In most cases, the money stolen would not be your burden as in the case of a debit card.

- Debit cards are protected only by an encrypted number, known as PIN. This PIN cannot give protection against identity theft. Anyone carrying the card can access the account if the PIN is known.

- In most cases, the issuing banks limit the maximum amount that can be withdrawn or transferred by the customer. This hinders business transactions where the volume and the value of the amount involved are considerably high.

- Only merchants having an electronic terminal can perform transactions through debit cards. Moreover, a customer can access an account only from the place where the issuing bank's outlet terminal exists.

3.2.4 Kisan Credit Card

The Kisan Credit Card scheme is a credit scheme introduced in August 1998 by Indian public sector banks. This model scheme was prepared by the National Bank for Agriculture and Rural Development on the recommendations of the R. V. Gupta Committee to provide advances for agricultural needs.

The Kisan Credit Card (KCC) scheme was introduced for issuing Kisan Credit Cards to farmers based on their holdings for uniform adoption by the banks so that farmers may use them to readily purchase agriculture inputs such as seeds, fertilizers, pesticides etc. and draw cash for their production needs. It was launched to meet comprehensive credit requirements of the agriculture sector by giving financial support to farmers.

The scheme is a Central scheme that provides farmers with timely access to credit. The scheme was launched in 1998 with the aim to provide short-term formal credit to farmers. It was created by the National Bank for Agriculture and Rural Development (NABARD).

The farmers who are applying should be able to raise a production credit of Rs. 5,000

or more. Farmers with a minimum age of 18 years and a maximum age of 75 years are eligible for this card. Besides the mandatory Crop Insurance, KCC holders should have the option to take benefit of Asset Insurance, Personal Accident Insurance scheme (PAIS), and Health Insurance. No processing fee should be charged up to a card limit of Rs. 3.00 lakhs. Let us discuss the features and benefits of Kisan Credit Card.

- Farmers are given credit for meeting their financial requirements of agricultural and other allied activities along with post-harvest expenses.
- Investment credit for agricultural requirements such as dairy animals, pump sets etc.
- Farmers can take out a loan of up to Rs.3 lakh and avail produce marketing loans.
- Insurance coverage for KCC scheme holders up to Rs.50,000 in the case of permanent disability or death. A cover of Rs.25,000 is given in the case of other risks.
- Eligible farmers will be issued a savings account with an attractive interest rate along with a smart card and a debit card in addition to the Kisan Credit Card.
- Flexible repayment options and hassle-free disbursement procedure.
- Single credit facility/ term loan for all agricultural and ancillary requirements.
- Assistance in the purchase of fertilizers, seeds, etc. as well as in availing cash discounts from merchants/ dealers.
- Credit is available for a period of up to 3 years and repayment can be made once the harvest season is over.
- No collateral will be required for loans amounting up to Rs.1.60 lakh.

3.2.5 Smart Card

A smart card is a plastic card with a built-in microprocessor, used typically to perform financial transactions. A smart card is a device that includes an embedded integrated circuit chip (ICC) that can be either a secure microcontroller or equivalent intelligence with internal memory or a memory chip alone. The card connects to a reader with direct physical contact or with a remote contactless radio frequency interface.

These cards are inserted into the card reader, which reads the information stored on the contact plate and carries out the required transaction. The most common examples of contact smart cards are credit cards, ATM cards, and SIM cards. The term 'smart card' is used to describe any card that is capable of relating information to a particular application such as magnetic stripe cards, optical cards, memory cards, and

microprocessor cards. memory and microprocessor cards are smart cards.

Fig 3.2.2 Smart Card

3.2.5.1 Applications of Smart Cards

Smart Cards provide a new set of technologies with a great deal of promise. Smart Cards provide a secure, portable platform for 'anytime, anywhere' computing that can carry and manipulate substantial amounts of data, especially an individual's personal digital identity. The most important areas where Smart Cards have been establishing their positions include;

- **Financial Services -** Financial institutions are looking to use Smart Cards to deliver higher value-added services to businesses and consumers at a lower cost per transaction. These services include money on a card, corporate card programmes, and targeted marketing programmes based on analysis of consumers' buying patterns.

- **Affinity Programmes** - Airlines, retailers, and other companies that offer a range of ancillary services and loyalty programs along with their basic product want to use Smart Cards to deliver these programmes with a higher level of service, improved ease of use, and at a lower cost. For example, airlines want to use Smart Cards not only as a vehicle for issuing and carrying tickets - even though the single benefit of being able to securely order/provide a ticket directly to chip cards via the Internet is substantial. Airlines also want to use the cards to provide tie-ins to their frequent-flyer programmes and to cross-marketing deals with auto rentals and hotels, as well as to provide simplified access to private airline lounges.

- **Cellular Phones** - Cellular phone services in the United States are losing $1.5 million per day because of fraud. Although Smart Cards offer a mechanism to secure cellular phones against fraudulent use, only smart Cards offer the ability to download new functions into a phone in real time.

- **Set-top Boxes** - Subscription satellite and cable services suffer from fraud problems similar to those in the cellular phone business. Once again, smart Cards offer security and the ability to add/update customer functions available to consumers in real time.

- **Secure Network Access -** Smart Cards can carry an individual's digital signature. With this ability, they provide a special mechanism to secure access to computer networks within a corporation, they help ensure that only individuals with the proper authority can get access to specific network resources, and they reduce the likelihood that hackers can break into a system.

Other Applications of Smart Card technology include Government, Healthcare, Information Technology, Mobile Communication, Banking, Loyalty Programs, Mass Transit, Driving Licensing, Electronic Toll Collection, Telephone Cards, etc

Recap

- Some of the most common types of Cards used in banking system are debit cards, credit cards, prepaid cards, and Forex cards
- Credit cards allow the user to borrow money from the bank and make purchases
- Debit cards are the most common type of bank cards and the simplest to use.
- Debit cards are also known as cheque cards.
- Debit cards look like credit cards or ATM cards but operate like cash or a personal cheque
- The Kisan Credit Card scheme is a credit scheme introduced in August 1998 by Indian public sector banks.
- This KCC scheme was prepared by the National Bank for Agriculture and Rural Development on the recommendations of the R. V. Gupta Committee to provide advances for agricultural needs.
- The scheme is a Central scheme that provides farmers with timely access to credit.
- A smart card is a plastic card with a built-in microprocessor, used typically to perform financial transactions

Objective Questions

1. What is a bank card?
2. What is a credit card?
3. What is a Debit Card?
4. What do you mean by KCC or Kisan Credit Card system?
5. What is a Smart Card?
6. What is the expansion of ATM?
7. What is an ATM?

Answers

1. Bank cards or Payment Cards are an essential part of the payment system set up by banking institutions that offer hassle free and cash free options to make payments and withdraw money as per the need of the card holder.
2. Credit cards allow the user to borrow money from the bank and make purchases
3. Debit cards are the most common type of bank cards and the simplest to use. They are associated with a bank account and allow you to pay in both physical and online stores and to withdraw cash at branches or ATMs.
4. The scheme is a Central scheme that provides farmers with timely access to credit.
5. A smart card is a device that includes an embedded Integrated Circuit Chip (ICC) that can be either a secure microcontroller or equivalent intelligence with internal memory or a memory chip alone.
6. ATM stands for Automated Teller Machines
7. An ATM is an electronic banking machine that allows customers to withdraw money with an ATM card and perform other banking transactions without the aid of banking staff.

Assignments

1. What are the advantages and disadvantages of a Credit Card?
2. Describe the procedures for getting a Credit Card?
3. What are the advantages and disadvantages of a Debit Card?
4. Explain the different applications of a Smart Card

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UNIT 3

Modern Aspects of Banking

Learning Outcomes

After completing this unit, the learner will be able to:

- explain the concept of Personal Identification Number (PIN), Electronic Fund Transfer (EFT), including NEFT and RTGS
- describe how the SWIFT system facilitates international money transfers
- identify the key features and benefits of Core Banking systems
- recognise the significance of the Indian Financial System Code (IFSC)

Prerequisites

In today's fast-paced world, banking is no longer limited to physical branches. With technological advancements, banking has evolved into a dynamic system that offers convenience, speed, and security. The way we manage our money, transfer funds, and even make payments has changed dramatically. Imagine being able to transfer money instantly, access your account securely from anywhere, or make international transactions with just a few clicks. These innovations are not only transforming the way we bank but are also essential in today's economy.

As an economics learner, understanding these modern banking systems will give you a deeper understanding into how the financial world operates. In this unit, learners will come across how systems like electronic fund transfers, core banking, and secure transactions are influencing the future of banking. These topics will help the learners to grasp the role of technology in making financial transactions faster, safer, and more efficient.

Keywords

PIN, SWIFT, NEFT, RTGS

3.3.1 Modern Aspects of Banking

The advent of Information Technology (IT) and cyber devices have changed the banking industry in India. Technology has become central to banking. That is why private sector and multinational banks have been able to survive in this competitive sector. Technology has changed the world of banking and the financial sector beyond recognition. Today every layman should know about the modern aspects of Banking. One important aspect of modern banking is the Personal Identification Number (PIN), which ensures that only you can access your account or make secure transactions. Another key development is the Electronic Fund Transfer (EFT) system, which includes methods like NEFT (National Electronic Funds Transfer) and RTGS (Real-Time Gross Settlement), making it easy to transfer money electronically between accounts. The SWIFT network further enables quick international money transfers. Moreover, Core Banking refers to the system that connects all bank branches and allows customers to access their accounts from any branch. The IFSC code helps in identifying specific branches of banks for smooth electronic transactions. Let us look into the details.

3.3.2 Personal Identification Number (PIN)

PIN stands for Personal Identification Number. It is a numerical code that is issued along with payment cards to the users. It is used during electronic financial transactions and is required to complete a transaction. Its purpose is to provide additional security to electronic or online transactions.

Fig 3.3.1 Entering PIN

A personal identification number, or PIN, is a string of at least four digits used to

unlock a bank account or card to which it has been assigned. A PIN is necessary to access the funds in a bank account with a debit card and to receive a cash advance with a credit card. Increasingly, PINs are used to protect all kinds of secure information, such as personal smartphones or utility bills.

Debit cards are the most common example in which a person uses the PIN while withdrawing money from their bank account through an ATM. The use of PIN is not limited to financial transactions. It is also used for various other purposes such as home security, in mobile phones, laptops, and other such equipment and machines.

A person can select a pin by changing the pin provided by the bank. The PIN should be hard to guess or difficult. It should not be related to personal information such as birthday, house number, vehicle number, etc

When a person uses a system that requires a PIN, the person enters the PIN that is verified by comparing it with the PIN stored in the system database. After verification is done, the user can access the system. So, a PIN does not identify a person personally.

PIN is used for various systems and networks such as mobile phones, laptops, computers, and more. However, the most popular usage of PINs is in online transactions like debit cards, credit cards, and other online payments.

Advantages of PIN

- It ensures safe and secure financial transactions.
- If you lost your card, no one could use your card without having your PIN.
- It provides access to various online and offline payment options and systems.
- Four digit PIN number is easy to remember, you don't need it to write anywhere.
- You can change it whenever you want by following the procedure mentioned by your bank.
- It gives additional protection to users.
- It gives access to different types of devices and network systems.
- There is no harm in using a PIN as it renders additional protection.

It is very important to keep your PIN secret as it authorises you to access sensitive information. You can adopt the following methods to keep your PIN secret.

- **Hide PIN Entry**: Do not let anyone see your PIN while entering it at an ATM or shop.
- **Do not write the PIN anywhere**: Do not write it on your debit card or at any other place where others can see it
- **Create Secure PIN**: Choose combinations that are hard to remember by others who happen to see it once. change your PIN immediately if you think someone has seen your PIN.

- **Do not re use the PIN:** A person with multiple bank accounts may not be able to remember all PINs. So, he or she may be tempted to reuse the same PIN for all accounts. Using one PIN for all accounts is not safe.

3.3.3 Fund Transfer

Fund transfer is designated as the movement of the funds or money from one bank account to another or from the sender to the receiver account. Fund transfer can be initiated through various modes such as National Electronic Fund Transfer, Real-time Gross Settlement, Immediate Payment Service, Unified Payments Interface, Electronic Fund Transfer, Net banking, Bank transfer, and more alternatives that are available.

3.3.3.1 Electronic Fund Transfer (EFT)

An electronic funds transfer is a widely used method for moving funds from one account to another using a computer network. Electronic funds transfers replace paper-based transfers and human intermediaries. Electronic funds transfer (EFT) is the electronic transfer of money from one bank account to another, either within a single financial institution or across multiple institutions, via computer-based systems, without the direct intervention of bank staff. An EFT can be initiated by a person or by an institution like a business.

Every time a banking customer uses his/ her credit or debit card, whether at a physical point-of-sale or online, he/she is engaging in an electronic funds transfer. Electronic funds transfers are secured by a personal identification number (PIN) or the login information that unlocks the customer's online banking service. An automated clearing house (ACH) processes the payment.

With the COVID-19 outbreak, digital payment adoption has accelerated. It has become the most popular way of transacting today and will stick around in the times to come. As more customers are becoming tech-savvy, businesses large or small are taking advantage of electronic funds transfers (EFT). To meet the rising demand for electronic money transfers, it is important for merchants and businesses to understand how they work. An electronic funds transfer (EFT) involves the movement of money from one bank account to another digitally. Also known as direct deposit, these transfers take place independently without any involvement of bank staff.

The digital transaction does not require heaps of documentation. Because of its simplicity, EFT has now become a predominant method of transfer of funds. It is also the most easily accessible and direct method of payment.

An EFT transfer usually involves two parties; the sender and the receiver of funds. An EFT payment process starts when the sender initiates a transfer. The payment request channels through a series of digital networks originating from a payment terminal over the internet. The sender's bank sends a request to the receiver's bank. Most payments are completed quickly.

Senders can be anyone from a business to an individual. They may pay an employee,

a vendor, or a service provider. Recipients can be individuals or entities like employees, service providers, goods suppliers, retailers, and utility companies.

EFT can be done to any bank account across the country. For example, you can transfer money to an account in a particular branch of SBI in New Delhi from Kerala by providing the IFSC Code.

You must consider factors like transfer limit and cost to decide the best method of transferring money online.

You can select from one of the following methods for making an electronic fund transfer from your account.

- Transact between different accounts of the same bank.
- Opt for NEFT to send money into a different bank's accounts
- Initiate transaction between your two linked accounts of the same bank
- Transfer money through RTGS into another bank's accounts
- Use Immediate Payment Services (IMPS) to transfer money into various accounts

3.3.3.2 National Electronic Funds Transfer (NEFT)

The acronym 'NEFT' stands for National Electronic Funds Transfer. It is an online system for transferring funds from one financial institution to another within India, usually the banks. The system was launched in November 2005. National Electronic Funds Transfer (NEFT) is a mode of online funds transfer that is introduced by the Reserve Bank of India (RBI). It quickly transfers money between banks throughout India. A bank branch must be NEFT-enabled for a customer to be able to transfer the funds to another party. NEFT is the most popular online payment option to transfer money. You can easily transfer money from one bank account to the other through this method. Companies use it mostly for salary transfers. Banks charge a fee for NEFT when you are transferring money to a different bank. They may charge anywhere between Rs. 2.50 to Rs. 25. However, the service fee is based on the amount being transferred.

Advantages and Disadvantages of NEFT

The National Electronic Fund Transfer (NEFT) is a payment platform which is used nation-wide by many banks. This allows the easy and hassle-free transfer of money from one bank account to another bank account. With the world slowly shifting to online banking, the concept NEFT has become very popular in the country and is an easy way of transferring funds. It eliminates the need to visit the bank to transfer funds, as you can transfer funds from while being at home. NEFT has the following advantages;

- With NEFT, you can easily transfer funds from one bank account of any branch to another account.
- It avoids the need for a physical instrument to transfer funds.

- There is no need for any physical presence of parties.
- It is a safe and secure payment method in which both the parties can be assured of the security without any worry of loss or theft of the physical instruments
- NEFT is easy, simple, and efficient.
- You need not have to visit the bank.
- It is almost a real-time fund transfer system to the beneficiary account in a safe way.
- You can initiate internet banking from any location.
- The confirmation of a transaction will be received through SMS notifications.
- The real-time transactions of NEFT gives assurance to both parties.

The disadvantages of NEFT are as follows;

- NEFT might not be easy for everyone to operate. A person having little computer or internet knowledge might find it difficult to operate and access this method.
- NEFT transactions using an unsecured browser makes your information get into the hands of a hacker.

3.3.3.3 Real Time Gross Settlement (RTGS)

The acronym 'RTGS' Stands For 'Real Time Gross Settlement'. RTGS is a funds transfer system where money is moved from one bank to another in 'real-time', and on a gross basis. RTGS is the fastest possible way to transfer money. 'Real-time' means that the payment transaction is not subject to any waiting period. The transaction will be completed as soon as the processing is done, and that the settlement of fund transfer instructions occurs individually (on an instruction-by-instruction basis). The transaction is treated as final and irrevocable as the money transfer occurs in the books of the RBI (Reserve Bank of India). This system is maintained by the RBI and is available during working days for a given number of hours. Banks using RTGS need to have Core banking to be able to initiate RTGS.

This form of EFT is allowed only on transfers for a minimum amount of Rs. 2 lakhs. However, there is no upper limit for the transaction amount. These transactions process during the RTGS business hours. Usually, the amount is transferred to the recipient's account within 30-minutes. Both the sender and receiver should hold accounts in RTGS enabled banks. The list of RTGS authorised banks is available on the RBI website.

The Remitter has to provide the following details;

- Amount to be remitted

- Account number to be credited
- Name of the beneficiary bank
- Name of the beneficiary customer
- IFS code of the receiving branch.
- Mobile number of the remitter.

The RTGS system is primarily meant for large value transactions. So, the minimum amount that can be remitted through RTGS is ₹2 lakh per day. The maximum amount is ₹10 lakh per day.

Under normal circumstances, the beneficiary branches are expected to receive the funds on a real-time basis as soon as the funds are transferred by the remitting bank. The beneficiary bank has to credit the beneficiary's account within 30 minutes of receiving the message of transfer of funds. If the funds are not credited to the beneficiary's account for any reason (like the account not existing or the account is in a freeze status), the funds will be returned to the originating bank within one hour or before the end of the RTGS business day, whichever is earlier.

Advantages of RTGS

- The fund transfer occurs in real time.
- RTGS is one of the safest as well as the fastest modes of interbank transfer.
- It is a paperless transfer of funds.
- There are no additional charges levied for RTGS transactions.
- The beneficiary is not required to visit the bank, to deposit the money.
- This facility is available on all business days, whose timings may vary from bank to bank.
- It offers immediate clearing.
- RTGS is now available 24*7 from Monday to Sunday.
- RTGS facility can be availed either online through mobile or internet banking or offline through the bank branch.
- It does not involve any credit and settlement risk for the recipients as every transaction is settled instantly.
- RTGS is predominantly used for high-value transactions.
- The system is highly reliable and is powered by the RBI.
- There are no transaction charges levied for RTGS requests initiated through

online modes

Disadvantages of RTGS

- RTGS does not provide the facility to track the transaction to its customers.
- The minimum amount that can be remitted through RTGS is Rs 2 lakh with no upper limit.
- The RBI of India has only implemented the positive confirmation in which the remitting bank receives a message of fund transfer to the beneficiary bank from the RBI.

3.3.4 Society for Worldwide International Financial Telecommunications (SWIFT)

SWIFT or the Society for Worldwide International Financial Telecommunications – is a system that banks use to securely send messages to each other. It is one of the key pillars of the financial world, connecting more than 11,000 member banks in some 200 countries and territories globally. Behind most international money and security transfers is the Society for Worldwide Interbank Financial Telecommunications (SWIFT) system. SWIFT is a vast messaging network, banks and other financial institutions use to send and receive information, such as money transfer instructions quickly, accurately, and securely.

SWIFT is a cooperative company under Belgian law and is owned and controlled by its shareholders (financial institutions) representing approximately 3,500 firms from across the world. In the era of global trade countries have sought safer and more secure ways to transfer funds between banks. Networks and intermediaries are often needed to ensure international transactions are executed smoothly. SWIFT Banking System is the name of the organisation that facilitates worldwide interbank financial communications.

With the introduction of SWIFT, banks send and receive money more conveniently and securely among themselves. In a SWIFT transaction, payment instructions are transmitted electronically from the payer. Depending on the process, funds will be moved between Nostro / Vostro accounts. If a bank wants to conduct international business, it usually opens a Nostro/Vostro account with a different bank. The Nostro and Vostro accounts both keep records of the money deposited into them. Based on an underlying network of Nostro and Vostro accounts, all banks involved in SWIFT transfers will transfer funds from one account to another. It refers to accounts between banks that are solely used for SWIFT transactions.

Due to both banks keeping records of deposits, they create two sets of ledgers, Nostro and Vostro, for the same account. Regarding Nostro and Vostro, Nostro is an account for holding money, while Vostro is an account that a bank opens in their books to receive money.

To transfer money between banks, the SWIFT protocol is used. The transfer occurs

as soon as the SWIFT message is received between two banks. By using a commercial account, money is transferred from one's account to another's. The banks charge a fee.

Fig 3.3.2 SWIFT Banking System

SWIFT was designed to help banks communicate faster, more securely, and more effectively in its original form. Especially in transferring money internationally, SWIFT acts as a messenger between banks, by communicating by delivering a message. It is through this message that instructions are transmitted to the receiving bank on how to process the payment.

- It is formally known as the Society for Worldwide Interbank Financial Telecommunication (SWIFT).
- It is a trusted messaging system for banks and other financial institutions around the world.
- It does not settle any money itself but provides instruction messages for just how to give and receive specific funds.
- It is controlled by the central banks of the G10 countries, the European Central Bank, and the National Bank of Belgium.
- It was established in 1973 and is based in Belgium.
- The Group of Ten is made up of eleven industrial countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) which consult and co-operate on economic, monetary, and financial matters.
- Prior to SWIFT, the only reliable means of message confirmation for international funds transfer was Telex.
- It was discontinued due to a range of issues such as low speed, security concerns, and a free message format.

- There are about 11,000 member banks in 200 countries and territories that use SWIFT.
- Since it began in 1973, SWIFT has become an integral part of the flow of global trade.
- India's financial system has access to the SWIFT.

Society for Worldwide Interbank Financial Telecommunication works like a transitional bank, it only monitors the transaction between or among the banks or financial institutions. More than 11,000 institutions all over the 200 countries and territories are connected with the SWIFT. It usually alerts the banks and financial institutions when the transaction(s) is/are going to take place. A fact about the Society for Worldwide Interbank Financial Telecommunication is that last year it received 42 million messages per day regarding international transactions between financial institutions and banks. This is 11% more transactions from the year 2020. You will be amazed to know that 1.5% transactions were made for Russia and by Russia.

With the help of a SWIFT transfer, you can make transactions in any currency and to any bank in the world. However, its implementation takes longer than a regular online transfer, on average about 3 working days. It is not always possible to determine the cost of a transfer in advance, since it depends on how many banks will act as an intermediary in a particular transaction. And most importantly, SWIFT does not solve the problem of small transfers.

You should submit the following information to the bank where you have an account:

- personal data of the transfer recipient, that is, the person or institution to whom you intend to send money in foreign currency.
- beneficiary's bank account number – required in International Bank Account Number (IBAN) format.
- beneficiary's bank SWIFT code Bank Identifier Code (BIC).
- purpose of transfer.
- the amount of the transfer in the currency of sending or receiving.

When transferring money in foreign currency, you must enter the SWIFT code. It is used to identify banks or other organisations that are members of the entire SWIFT system. This allows financial transactions to be carried out more efficiently and mainly automatically. The SWIFT code is required when transferring between two different countries.

In addition, there are costs of the so-called intermediary banks, which can amount to several tens or several hundred hryvnias or euros. Who pays this cost depends on the chosen split option (this decision always remains with the person who orders the transfer).

3.3.5 Core Banking

Core banking functions will include transaction accounts, loans, mortgages, and payments. Banks make these services available across multiple channels like automated teller machines, Internet banking, mobile banking, and branches. Core banking systems are aimed at empowering existing and probable customers to have a greater freedom of their account transactions. With technological evolutions, transactions are now safer and faster. The fact that these transactions can be executed remotely, from any part of the world has made core banking systems a significant aspect of banking these days.

Core banking can be defined as a back-end system that processes banking transactions across the various branches of a bank. The system essentially includes deposit, loan, and credit processing. Among the integral core banking services are floating new accounts, servicing loans, calculating interests, processing deposits and withdrawals, and customer relationship management activities.

Core banking always brings down operational costs considerably, ensuring lesser manpower requirements for execution. It also enables greater accountability of the customers. Software application-based platforms make core banking systems user-friendly and more efficient. The benefits of core banking systems are numerous. Core banking simplifies banking processes and makes it more convenient for the customers and expands the outreach of the banks to remote places.

3.3.5.1 Core Banking in India

The first attempt was made in 1981 and it was further extended in 1984. The Indian banks began the process at the branch level. The introduction of technology into the banking system has caused a massive transformation in the way banks function. The traditional banking methods have made way for the latest technological innovations with highly sophisticated systems. Among these, one of the significant moments was the adoption of Core Banking in India.

The Core banking solutions are essential for the proper functioning of banks. It is a vital part of the banking system, which helps in serving their clients and customers with excellent service.

Core banking is a centralised system, or a network made by a bank and its branches. It allows the customers to access their bank accounts to manage and perform basic transactions from any branch of the bank where they hold an account.

Some of the underlying core banking solutions include deposit, loans, payments etc. These services are made accessible to customers with the help of Core banking software. Core banking system uses information communication technology to simplify the banking procedures and processes for its various applications.

The requirement for computerised banks in India was felt in the early 1980s. The Indian banks applied the process at the branch level. Various national committees were formed by the government to modernise the banking system in India.

In the late 1980s, the then deputy governor of Reserve Bank of India (RBI) Dr C Rangarajan implemented the concept of core banking in India. It formed a platform for facilities like telebanking, off-site ATMs, and customer terminals.

In the 1990s, core banking was transformed when private sector banks and foreign banks started having access to the Indian banking industry. The progress continued due to globalisation, liberalisation, and the introduction of **TRAI** (Telecom Regulatory Authority of India).

Implementation of the core banking system in India was a landmark moment for the Indian banking industry. It has transformed the way money is handled and the functioning of banks. Core banking could be just a beginning, and paperless and branchless banking systems could be the future of the Indian banking industry.

Objectives of Core Banking System

The primary objective of the core banking system is to improve the customer experience. It aims to provide convenient banking to its customers where the customers can access banks anytime and from anywhere.

Another objective of the core banking system is to make informed decisions with facts and figures. The different process of core banking allows the storage of data in a proper format. All such data can be accessed by an authentication system and helps the customers to make informed decisions. Moreover, it allows generation and provides statutory and regulatory reports to the regulators of the government.

3.3.5.2 Benefits of Core banking

Banking and financial institutions have benefited immensely after the introduction of core banking in India. It offers excellent support to the bank and is an integral part of their daily businesses. It has significantly reduced the burden of manual tasks which consumes time and money. It has made assessing, managing, and upgrading of data simple and has increased efficiency and productivity of the employees. There are various benefits of core banking for customers as well as for banks. These are as follows:

- Quicker services at banks for transactions.
- Banking can be accessed from anywhere thus eliminating branch banking.
- Provision of 24*7 banking services.
- Quicker processing of payments through internet banking and mobile banking.
- All branches access applications from central servers; therefore, deposits made in any branch are shown immediately, and the customer can withdraw money from any branch throughout the country.
- Banks can retain customers through better service.
- Accuracy in transactions and minimisation of errors for banks.

- Improved management and documentation of records.
- Easier to submit various reports to the government and to the Reserve Bank of India; and
- It provides convenience in opening accounts, processing cash, calculating interest and in implementing changes in policies of banks.

When compared with traditional banking methods, core banking is more convenient and simplified.

3.3.6 The Indian Financial System Code (IFSC)

The Indian Financial System Code (IFSC) is a unique 11-digit alphanumeric code that is used for online fund transfer transactions done via NEFT, RTGS and IMPS. You can find the IFS code on the cheque leaf that is provided by the bank. The Reserve Bank of India (RBI) assigns the IFS codes to the bank.

The full form of IFSC is the **Indian Financial System Code**. IFSC code is an alphanumeric code of 11 characters, which helps to smooth the progress of electronic payments in India. For every bank in India, it can be used to identify and classify each branch. An individual may immediately describe a bank and its branch within the given IFSC code. This code is explicitly mentioned in the cheque book.

To obtain any bank's IFSC code, the person must provide the following details.

- The name of the bank
- Name of the state where the bank is located
- Name of district
- Name or address of the branch

3.3.6.1 Importance of IFSC

- RBI provides the IFSC Code for the identification and classification of banks and their branches that provide RTGS, IMPS and NEFT facilities.
- IFSC code allows RBI to verify and evaluate financial transactions without disruption and error.
- RBI can administer and handle all online banking transactions such as RTGS, NEFT and IMPS explicitly Via IFSC code.

Advantages of IFSC

IFSC stands for Indian Financial System Code. The code comprises 11 characters. The first 4 characters indicate the name of the bank. For example, the first four letters of

the code, SBIN0000XXX indicate the State Bank of India. The fifth character is 'zero' and it is reserved for future use. The last six characters indicate the unique branch code.

By using IFS code, the location of the bank branch in a city, district or state can be done very easily. The online fund transfer option NEFT and RTGS can be accomplished without errors by using the IFSC.

The following are the advantages of IFSC:

- It makes financial transactions smoother. With the help of IFSC, transactions can be processed worldwide and in a few steps.
- It speeds up the funds transferring process. Thanks to online banking, you can do banking from the comfort of your home. It is very helpful, especially when you have to transfer money on an urgent basis.
- Frauds are reduced - With each bank and its respective branches allotted a unique IFS code, an extra layer of security is added to your transactions.
- Fund Transfer Made Easier - You can access your net banking account easily anytime, anywhere.
- Online Banking made Possible - Paying bills, paying for an order, recharging your phone, transferring funds online is possible because of IFS code.

Internet banking has become an indispensable necessity to individuals transferring funds. Today, more and more customers are using net banking for sending and receiving payments. The funds transferred through the EFT system are not only secure and safe but also reach the concerned party in the shortest possible time, within 24 to 48 hours. The net banking users are only required to submit certain facts and IFSC Code of the beneficiary bank branch to complete the fund transfer transaction smoothly.

The advantages and disadvantages of net banking clearly shows that if you take certain precautionary measures such as keeping your password safe, change it from time to time, hide it or memorise it without leaving any visible password record you get the best solution for safe and secure online bank transactions.

Recap

- A personal identification number (PIN) is a numerical code issued with a payment card.
- Pin is required to be entered to complete various financial transactions.
- Debit cards are the most common example in which a person uses the PIN while withdrawing money from their bank account through an ATM.
- Fund transfer is designated as the movement of the funds from the sender to the receiver account.
- An electronic funds transfer (EFT) is the electronic transfer of money over an online network.
- The acronym 'NEFT' stands for National Electronic Funds Transfer.
- NEFT is an online system for transferring funds from one financial institution to another (usually the banks) within India.
- The system was launched in November 2005,
- The acronym 'RTGS' Stands For 'Real Time Gross Settlement'.
- RTGS is a funds transfer system where money is moved from one bank to another in 'real-time', and on a gross basis.
- RTGS is the fastest possible way to transfer money.
- All ATM transactions are powered by EFT systems.
- Electronic Funds Transfer (EFT) is the process by which a user of one bank can transfer money from their account to another by way of payment. EFT is known as direct deposit.
- SWIFT is a system that banks use to securely send messages to each other.
- Swift connecting more than 11,000 member banks in some 200 countries and territories globally.
- SWIFT is controlled by the central banks of the G10 countries, the European Central Bank, and the National Bank of Belgium.
- Core banking can be defined as a back-end system that processes banking transactions across the various branches of a bank.
- Core banking system is an operating software or system employed by banks to provide core banking solutions to their clients.

- The full form of IFSC is the Indian Financial System Code.
- The Indian Financial System Code (IFSC) is a unique 11-digit alphanumeric code that is used for online fund transfer transactions done via NEFT, RTGS and IMPS.
- IFSC code format: The first 4 digits of the IFSC represent the bank and the last 6 characters represent the branch. The 5th character is zero.

Objective Questions

1. What is a PIN?
2. What is EFT?
3. Which are the different methods of EFT?
4. What is NEFT?
5. What is the full form of RTGS?
6. What is (ECS) or Electronic Clearing Services?
7. What is the expanded form of SWIFT?
8. What is Core Banking?
9. What is the full form of IFSC?
10. What is IFS Code?

Answers

1. A personal identification number (PIN) is a numerical code issued with a payment card that is required to be entered to complete various financial transactions.
2. Electronic Funds Transfer (EFT) is the process by which a user of one bank can transfer money from their account to another by way of payment. It is also called a direct deposit.

3. NEFT, RTGS, IMPS, ATM and UPI.

4. NEFT is an online system for transferring funds from one financial institution to another within India, usually the banks. The system was launched in November 2005,

5. 'RTGS' Stands For 'Real Time Gross Settlement'

6. Electronic Clearing System (ECS) is an electronic method of fund transfer from one bank account to another.

7. Society for Worldwide International Financial Telecommunications

8. Core banking system is an operating software or system employed by banks to provide core banking solutions to their clients. It helps the banks in carrying out the basic functions of the banks.

9. The full form of IFSC is the Indian Financial System Code

10. The Indian Financial System Code (IFSC) is a unique 11-digit alphanumeric code that is used for online fund transfer transactions done via NEFT, RTGS and IMPS.

Assignments

1. What are the advantages of PIN?
2. Describe the benefits of EFT?
3. What are the advantages and disadvantages of NEFT?
4. What are the advantages and disadvantages of RTGS?
5. Write a short note on SWIFT banking system.
6. What are the features of Core banking?
7. Describe the benefits of Core banking
8. Write a note on IFSC.

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BLOCK

Reserve Bank of India

UNIT 1

Reserve Bank of India

Learning Outcomes

After completing this unit, learners will be able to:

- understand the role of central bank in maintaining price stability of a country
- discuss the functions of the Reserve Bank of India
- study the structure and management of RBI

Prerequisites

The banking sector in India is undergoing a structural transformation under the influence of globalisation, deregulation, technological advancement, and institutional and legal reforms. While the liberalised environment has opened new avenues of business for banks, it has led to a competitive environment. To survive in this era, banks have been innovating, diversifying, and sharpening their banking skills and services. Banking regulation and supervision of India has been progressively aligned with international best practices and suitable adaptations. Technology has made an impact on the Indian banking industry, 'anywhere banking' and 'anytime banking' has become a reality.

Central banks occupy a key position in the institutional fabric of the modern economy. The functions of the modern Central bank are different from what it was in the early central banks founded in Europe in the 17th century. The evolution of central banking in the Indian context has its own specificity. The RBI, while discharging its statutory responsibilities, has played a key role in the nation-building process, particularly in the development of the financial sector. In fact, institution-building constitutes a distinguishing feature of the central bank in India.

Keywords

RBI, Currency Management, Monetary Policy, Financial Supervision, Foreign Exchange, Banking Regulation, Financial Stability

4.1.1 Reserve Bank of India

In any economy, the government and the central bank play a key role to facilitate as well as to regulate the overall economic activities. The banking system and money supply in the economy is managed and controlled by the central bank of a country. Usually, the Central Bank is a government-owned and operated institution that has the following responsibilities.

1. Issuing currency
2. Managing money supply
3. Administering rate of interest
4. Regulating lending and borrowing policies of commercial banks
5. Undertaking governmental banking activities
6. Maintaining foreign exchange reserves, the external value of money and the country's balance of payment

4.1.1.1 Establishment and History of RBI

The origin of the Reserve Bank of India can be traced back to 1926, on the recommendation of the Hilton Young Commission (Royal Commission on Indian Currency and Finance). Before the creation of the RBI, the Imperial Bank of India, which emerged as a result of the amalgamation of the three Presidency Banks of Bengal, Bombay, and Madras in 1921, performed certain central banking functions, except for currency management. The control of currency management continued to be with the Government of India. Pointing out this weakness, in which the control of currency was with the government whereas the control of credit was with the Imperial Bank, the commission recommended that both powers should be given to the new central bank. The commission recommended the establishment of a central bank called, 'The Reserve Bank of India' by assigning all central banking functions to it.

The Reserve Bank of India Act of 1934 established the Reserve Bank of India and on January 14, 1935, the RBI came into existence as a private shareholders' bank, though it was formally inaugurated on April 1st 1935. The objective of establishing the RBI, as stated in the preamble of the RBI Act 1934, was to "regulate the issue of banknotes

and the keeping of the reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage". In 1949, the RBI was nationalised, fully owned by the Government of India. The head office is in Mumbai and its executive head is called the Governor.

4.1.1.2 Role of RBI

Since the setting up of the Reserve Bank of India in 1935, its role in the financial sector and financial market development has undergone significant changes. The various roles of the Reserve Bank of India are explained as follows:

1. **Note Issuing Authority:** The RBI has the sole right or authority or monopoly of issuing currency notes other than one-rupee notes and coins of smaller denominations, which is vested with the Government of India.

2. **Government Banker:** The Reserve Bank is the banker to the Central and the State Governments. It provides all banking services such as acceptance of deposits, withdrawal of funds by cheque, making payments as well as receipts and collection of payments on behalf of the government, transfer of funds and management of public debt.

3. **Banker's Bank:** The RBI has a special relationship with commercial and cooperative banks and the major part of its businesses is with these banks. The bank controls the volume of reserves of commercial banks and thereby determines the deposit creating ability of the banks. Similarly, in times of need, the banks can borrow funds from the RBI, so it is called the 'Bank of Last Resort'.

4. **Supervising Authority:** The RBI has vast powers to supervise and control commercial and cooperative banks with an aim to develop an adequate and sound banking system in the country. Initially, the RBI used to give only orders but now it undertakes inspection of commercial banks and recommends measures. It has the following powers.

   - To issue licences for the establishment of new banks and the setting up of bank branches.
   - To prescribe minimum requirements regarding paid-up capital and reserves, transfer of reserve fund and maintenance of cash reserve and others.
   - To inspect the working of banks in India as well as abroad, in respect of their organisational setup, the branch expansion, mobilisation of deposits, investments and credit portfolio management, credit appraisal, region-wise performance, profit planning, manpower planning and so on.

5. **Exchange Control:** One of the main functions of the RBI is to maintain the stability of the external value of the rupee. It perceives this objective through its domestic policies and regulations of the foreign exchange market.

   1. To administer the foreign exchange control.

2. To fix the exchange rate system and manage the exchange rate between the rupee and other currencies.

3. To manage exchange reserves.

4. To interact with the monetary authorities of other countries and with international financial institutions such as the IMF, World Bank etc.

Apart from performing the functions already mentioned, the RBI has rendered developmental services which have strengthened the country's banking and financial structure. This has helped in mobilising savings and directing credit flows to desired channels thereby helping to achieve the objective of economic development with social justice.

4.1.1.3 Functions of RBI

The RBI performs various monetary policy functions. Similarly, it regulates and supervises financial institutions to ensure financial stability. Following are the functions performed by the RBI:

1. Monetary Policy Formulation and Implementation

Monetary policy is the defining function of a central bank. In every country, the central bank is identified with the function of designing monetary policy. The central bank's control over the interest rate, supply of money and liquidity are decisive in influencing general economic activities like consumption, investment and ultimately economic growth. Thus, monetary policy can be termed as the policy of the central bank regarding the use of interest rate and supply of money to influence the general economic activities. Through this, the central bank can influence the major macroeconomic variables such as price level, stability of the financial institutions and economic growth.

2. Financial Regulation and Supervision

The RBI is the regulator for most of the financial sector comprising money market, foreign exchange market, government securities market, Non-Banking Financial Intermediaries, credit information companies, and also the market for certain types of financial derivatives.

> **Financial Derivatives** are financial instruments that are linked to a specific financial instrument or indicator or commodity, and through which specific financial risks can be traded in financial markets in their own right.

The RBI is responsible for organising a sound and healthy system of commercial banking. Supervision means onsite and offsite monitoring to ensure that the institutions are safe and healthy and are adhering to the RBI instructions. Norms and efforts for risk-based supervision are designed by RBI to make effective supervision of financial institutions. Regulatory norms, NPA (Non-Performing Asset) norms, CRAR (Capital to Risk-weighted Assets Ratio) etc., are vital to ensure the stability of the financial system.

For supervision purposes, the RBI has a dedicated wing called 'the Board of Financial Supervision' that was established in 1994.

3. RBI as the Banker to the Banks

As a banker to the banks, RBI provides certain services to the scheduled commercial banks which are vital for the day-to-day operations of the banks. These services enhance their stability and health.

1. Enable smooth and swift clearing and settlement of interbank transactions RBI also facilitates fund transfer among banks, through RTGS, NEFT etc.,

2. The RBI gives account facilities to banks and banks maintain cash reserves with the RBI.

3. The RBI, through its subsidiary Deposit Insurance and Credit Guarantee Corporation (DICGC), gives deposit insurance facilities to banks.

4. The RBI gives lender of last resort support to banks.

To avail all the banking facilities from the RBI, banks start a current account with the RBI and thus banks have to maintain minimum cash reserves in their current account. Scheduled commercial banks have the right to assess the payment and settlement system run by RBI, the use of deposit insurance facility, to get liquidity from the central bank by using Liquidity Adjustment Facility beside the lender of last resort facility. There are certain obligations imposed by RBI on banks in the form of maintaining CRR and SLR and fulfilling priority sector lending.

RBI also acts as a lender of last resort. RBI comes to rescue the bank that is solvent but faces temporary liquidity problems by supplying it with much-needed liquidity when no one else is willing to extend credit to that bank. RBI extends this facility to protect the interest of the depositors of the bank and to prevent possible failure of the bank.

4. RBI as a Banker to the Government

Since its inception, the Reserve Bank of India has undertaken the traditional central banking function of managing government banking transactions. The Reserve Bank of India Act 1934, requires the Central Government to entrust the Reserve Bank with all its money, remittance, exchange, and banking transactions in India and the management of its public debt. The government also deposits its cash balances with the RBI. The RBI also act as a banker to the State Governments in India except for Sikkim.

Reserve Bank manages the government's banking transactions by

1. Maintaining accounts of the government by handling their day-to-day banking transactions.

2. Holding custody of cash

3. Lending temporary loans to the government

4. Issue and management of government borrowings

The RBI manages all new issues of government loans, servicing the public debt outstanding and preparing the market for government securities. Various measures are taken to ensure the success of governments borrowing for mobilising resources. It involves new issues of rupee loans, payment of interest and the repayment of these loans and other operational matters such as debt certificates and their registration.

The Department of Government and Bank Accounts discharges the core central banking function of acting as a banker to the government and banker to banks. The RBI maintains principal deposit accounts of Central and State Governments at a Central Account section of the RBI, Nagpur except for the Sikkim Government.

5. Management of Foreign Exchange Reserves and Foreign Exchange Management

The RBI has the responsibility to manage the foreign exchange reserves. The RBI is also the administrator of the Foreign Exchange Management Act (FEMA) 1999, it has the function to regulate foreign exchange markets. The RBI prescribes various norms for currency convertibility, norms for foreign investors in India, Indian investors abroad, borrowing by Indian companies and business from foreign markets like external commercial borrowings, remittance norms, currency future trading etc. Regulation related to the forex reserves and FEMA helps the RBI indirectly to stabilise the exchange rate. The RBI is the custodian of forex reserves and it has the responsibility for managing these reserves by investing them in a productive manner.

The Foreign Exchange Market is managed by an intermediate exchange rate system called Managed Flexibility where the exchange rate is basically determined by the operation of market forces like demand and supply. But during extreme volatility, RBI intervenes in the foreign exchange market without any notice.

6. RBI Facilitates the Payment and Settlement System

The payment and settlements system is the facilitating environment for the conduct of payment in the economy. It is the backbone of the entire economic and financial activities. Now the payment system of the country has completed its transition to digital payments from paper-based payments.

7. Currency Management

The management of currency is one of the core functions of the Central Bank which commands a high degree of public visibility. Presently barring coins, RBI is the sole authority for the issue of currency in India. Coins are issued by the Central Government which supplies them to the RBI on the demand. RBI puts the coins into circulation on behalf of the Central Government.

In India, there are four printing presses that print and supply banknotes. These are

1. Bharatiya Reserve Bank Note Mudran Private Limited, Salboni, West Bengal
2. Bharatiya Reserve Bank Note Mudran Private Limited, Mysore, Karnataka

3. Currency note press, Nasik, Maharashtra

4. Banknote press, Dewas, Madhya Pradesh

Coins are minted by the Government of India. The Reserve Bank is the agent of the government for distribution, issues and handling of coins. Following are the four mints in operation:

1. Indian Government Mint, Noida, Uttar Pradesh

2. Indian Government Mint, Mumbai

3. Indian Government Mint, Hyderabad

4. Indian Government Mint, Kolkata

8. Development Role

The developmental role of the RBI includes ensuring credit availability to the various productive sectors of the economy. Besides this, establishing institutions designed to build the country's financial infrastructure, expanding access to affordable financial services and promoting financial inclusion, financial education and literacy are other developmental functions of RBI. Many development programmes like Priority Sector Lending, Lead Bank Schemes, sector-specific Refinance Facilities are examples of RBIs developmental support.

9. Research and Statistics

Central banks across the world are known to produce reliable data and to conduct qualitative research on issues related to the economy. The RBI has also made commendable efforts in this field; it has several publications, working papers and lecture series on economic issues. The annual report, the monthly bulletin, the report on trends and progress of banking in India and the financial stability report are some publications of the central bank. The Monetary Policy Report of the RBI gives details about the monetary policy decisions of the central bank.

4.1.1.4 Structure and Management of RBI

Central Board of Directors (CBD)

The Reserve Bank affairs are governed by a Central Board of Directors. The board is appointed by the Government of India in keeping with the Reserve Bank of India Act. It is the apex body in the Reserve Bank's organisational structure. The official members and the non-official members are appointed by the Government.

The Central Board has the primary authority and responsibility for the oversight of the activities of The Reserve Bank. It delegates specific functions to the Local Boards and various committees. Other wings of RBI, like the Board for Financial Supervision and other technical committees, derive their powers from the CBD. The CBD members are appointed by the Government of India for a period of 4 years. The RBI Governor

can have a maximum tenure of 5 years. The Governor has to convene the CBD meeting at least 6 times a year and at least once in each quarter and he presides over the board meeting.

Members of CBD

In the CBD, there are official and non-official members. Five members are official members and come from the RBI - the Governor and 4 Deputy Governors. The government can nominate the remaining 14 who are non - official members from different fields. Of these, four are from the Local Boards of the RBI.

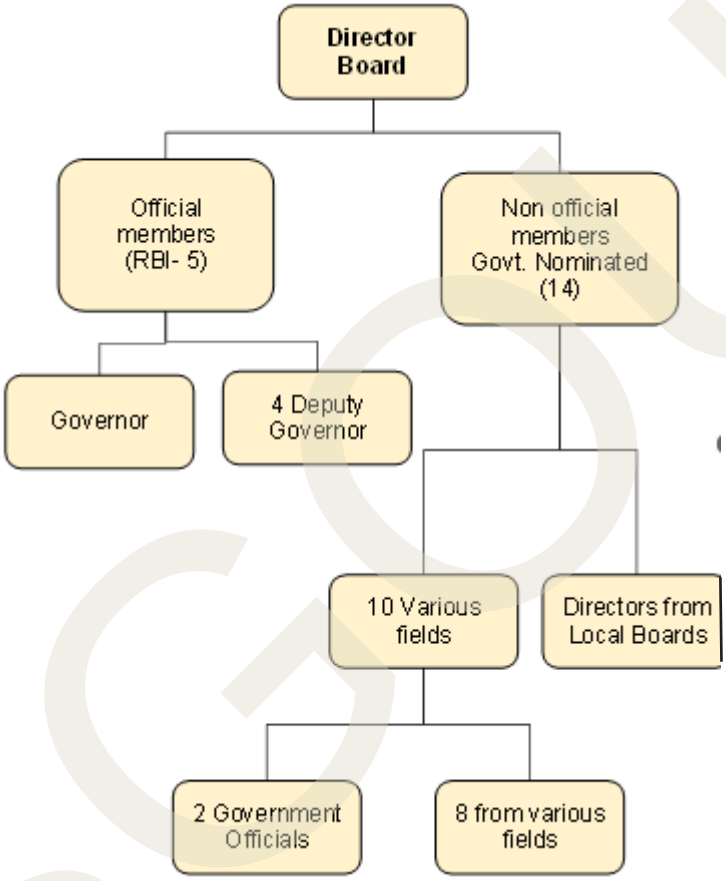

Fig 4.1.1 Composition of RBI's Director Board

Local Boards

Local Boards are to advise The Central Board on local matters and to represent the territorial and economic interests of local cooperatives and indigenous banks. It also performs other functions as delegated by the Central Board from time to time. Local Boards are constituted for the Western area, Eastern area, Northern area, and Southern area. It consists of 5 members each. The members are appointed by the Central Government and shall hold office for a term of 4 years.

Board for Financial Supervision (BFS)

The Reserve Bank of India performs the supervisory function under the guidance of the Board for Financial Supervision. The board was established in 1994 as a committee of The Central Board of Directors of the Reserve Bank of India under Reserve Bank

of India regulations, 1994. The primary objective of BFS is to undertake consolidated supervision of the financial sector comprising Scheduled Commercial and Cooperative banks, All India Financial Institutions, Local Area Banks, Small Finance Banks, Payment Banks, Credit Information Companies, Non-Banking Finance Companies and Primary Dealers. The board is required to meet normally once every month. It deliberates on inspection reports, periodic reviews related to banking and non-banking sector and policy matters arising out of or having relevance to the supervisory functions of Reserve Bank.

The Reserve Bank of India has 27 regional offices, most of which are in state capitals and 4 sub-offices. RBI also has 6 training establishments of which RBI Academy, College of Agricultural Banking and Reserve Bank of India Staff College are part of RBI. Others are autonomous such as National Institute for Bank Management, Indira Gandhi Institute for Development Research (IGIDR), Institute for Development and Research in Banking Technology (IDRBT).

Subsidiaries of the RBI

The RBI fully owns some of the major institutions of monetary policy importance. It has a cent per cent shareholding in Deposit Insurance and Credit Guarantee Corporation (DICGC) and Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL), Reserve Bank Information Technology Private Limited (ReBIT), Indian Financial Technology and Allied Services (IFTAS), and Reserve Bank Innovation Hub (RBIH). Earlier, the RBI had full ownership in NHB and NABAD. But in April 2019, the government bought the entire shareholding in these institutions from the RBI.

Recap

- (RBI) manages and controls money supply, interest rates, and banking policies in India
- Established in 1935 after the Hilton Young Commission's recommendation to centralise currency control
- RBI is responsible for issuing currency, managing government banking transactions, and maintaining foreign exchange reserves
- Supervises commercial and cooperative banks
- Ensure a round banking system
- As the banker to the government, the RBI handles government accounts, remittances, and public debt.
- Formulates and implements monetary policy, influencing economic activities like consumption and investment
- RBI regulates the financial sector
- Central bank manages foreign exchange reserves
- It facilitates the payment system and supports digital payment transition in India
- RBI manages currency, including notes and coins, and oversees their distribution
- Its developmental role includes ensuring credit availability, promoting financial inclusion, and supporting financial literacy

Objective Questions

1. What is the central bank of India?
2. Who has the sole authority to issue currency notes in India?
3. Which commission recommended the establishment of the RBI?
4. When was the RBI established?

5. Where is the headquarters of the RBI located?
6. What is the executive head of the RBI called?
7. In which year was the RBI nationalised?
8. Which bank performed certain central banking functions before the creation of the RBI?
9. Under which Act was the RBI established?
10. What is the function of the RBI that involves maintaining the external value of the Indian Rupee?
11. Which body within the RBI oversees financial supervision?
12. What is the term used when RBI supplies liquidity to a bank facing temporary issues?
13. What facility allows smooth interbank transactions facilitated by the RBI?
14. Which Act governs foreign exchange management in India?
15. What system determines the exchange rate in India?

Answers

1. Reserve Bank of India
2. Reserve Bank of India
3. Hilton Young Commission
4. 1935
5. Mumbai
6. Governor
7. 1949
8. Imperial Bank of India
9. Reserve Bank of India Act, 1934

10. Exchange Control

11. Board of Financial Supervision

12. Lender of Last Resort

13. RTGS/NEFT

14. FEMA 1999

15. Managed Flexibility

Assignments

1. Discuss the major functions of RBI.
2. Explain the role of RBI.
3. Elaborate on the structure and management of RBI.
4. Can RBI can manage the price stability of the country through monetary policy. Critically examine.

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UNIT 2

Monetary Policy

Learning Outcomes

After completing this unit, learners will be able to:

- understand the working of the monetary policy
- know about the objectives of the monetary policy
- understand various instruments of the monetary policy
- understand the functioning of various instruments to regulate and stabilise the economy.

Prerequisites

Nowadays, the RBI's monetary policy implementation directly or indirectly affects the daily life of the common people. Because the policy affects the economic activities as well as the welfare of the people. For example, If the RBI signals a decline in the interest rate, loans available from banks become less costly as they can reduce the rate of interest on loans. Households take loans to make consumption expenditures, business firms or corporates take loans to finance investment activities. The increase in loans raises consumption demand. Production, investment, employment, and income of the people increases. All these happen in a related sequential manner.

So, from the above discussion, you got a fair idea about the significance of monetary policy in the macroeconomic management of the country. The two relevant channels through which the central bank's monetary policy influences economic activity are the interest rate channel and the credit supply channel. For the understanding of the monetary policy and its working, basic knowledge about concepts like CRR, Repo, SLR etc., are not enough. Rather, an overview of all concepts including the monetary policy framework, operating procedure of monetary policy and operating target of monetary policy are necessary.

This unit discusses the working of monetary policy, through its various instruments, to attain various targets of price stability and supply of money.

Keywords

Monetary Policy, RBI, Inflation Targeting, Price Stability, Financial Stability, Credit Flow, CRR, SLR, Repo Rate, Reverse Repo Rate, Liquidity Adjustment Facility, Open Market Operations, Bank Rate, MSF, Financial System

4.2.1 Monetary Policy

Monetary and fiscal policies are regarded as the important tools of macroeconomic policies. The classical and neoclassical economists have paid greater importance to the monetary policy. However, during the days of depression the monetary policy failed to achieve its objectives. Prof. J.M. Keynes in his book "*General Theory of Employment, Money and Interest*" published in 1936 has regarded fiscal policy to be more important than monetary policy. The fiscal measures advocated by Keynes helped so many countries to solve the problem of depression and thus fiscal policy became more popular than monetary policy.

After 1960, there was a problem of inflation in countries like America, England etc. Prof. Friedman, Prof. Tausing and so many monetary economists then advised to adopt monetary measures. In this way, monetary policy again became more popular. Nowadays, almost all the countries in the world are using these policies for achieving different objectives as per their requirements.

Monetary policy refers to the policy of the central bank with regard to the use of monetary instruments under its control to achieve the goals specified in the RBI Act 1934. The Reserve Bank of India (RBI) is vested with the responsibility of conducting monetary policy and implementing it through a wide network of commercial banks and other financial institutions. It refers to the policy which pertains to money supply and bank credit in the country. It is necessary to regulate the money supply and bank credit in a country so as to ensure the proper functioning of the economy. The RBI's power to administer monetary policy basically comes from some of its money-related functions, such as the issuer of the currency, controller of credit given by the commercial banks and provider of interest rate and it influences the economic activities by using these policies. Monetary policy refers to the use of monetary instruments under the control of the central bank to regulate market tools such as interest rate, money supply and availability of credit with a view to achieving the objectives of economic policy.

According to D.C. Aston, "monetary policy involves the influence on the level and composition of aggregate demand by the manipulation of interest rate and availability

of credit". In the words of professor H.D. Johnson "By monetary policy, we mean any conscious action undertaken by monetary authorities to change the quantity, availability or cost (interest rate) of money".

The conduct of monetary policy has been changing in response to the process of financial liberalisation. The operating procedure of monetary policy changed dramatically with the opening up of the economy in the 1990s.

4.2.1.1 Objectives of Monetary Policy

The objectives of monetary policy are drawn from the Reserve Bank of India Act 1934. Prior to its amendment in 2016, this Act set out the RBI's objective as "to regulate the issue of banknotes and keeping of reserves with a view to securing monetary stability and generally to operate the currency and credit system of the country to its advantage". Securing monetary stability was the prominent objective of RBI. The RBI Platinum Jubilee document mentions the objectives of monetary policy under three heads:

1. **Maintaining price stability:** Price stability is a situation where the rate of increase or decrease in price does not distort the general economic activities like investment, production, savings etc. The two instances of price instability are inflation and deflation. Price stability does not mean the absence of inflation, as a low level of inflation is helpful to the economy. Thus, price stability is expressed as low and stable inflation.

2. **Ensuring the adequate flow of credit to the productive sectors of the economy to support economic growth:** Monetary policy influences economic growth by ensuring adequate flow of credit to different sectors at reasonable rates. For this, the RBI frames its monetary policy on the one hand by facilitating credit delivery using the banking system and on the other by maintaining a growth-friendly interest rate policy. Both the quantities of credit as well as the cost of it are important to support economic growth.

3. **Financial Stability:** Financial stability means financial institutions, individually and collectively, being able to deliver their functions properly by withstanding external shocks and avoiding internal weaknesses. Since the central bank has the power to discipline the banking system, they should have the responsibility to ensure the safe working of the financial institutions as well.

The Draft Report on the Strategic Action Plan for the Reserve Bank of India (1993-2002) elaborates the objective of RBI monetary policy in a much broader angle "containing inflation and promoting economic growth; advising the government on deficit financing and public debt management; balance of payment and management of foreign exchange reserves; and the development of the financial sector; promotion of a non-currency form of payment while improving the quality, design and availability of currency". In a nutshell, the objective of maintaining price stability has got primacy after the introduction of inflation targeting in the country.

Inflation targeting is a central bank strategy of specifying an inflation rate as a goal and adjusting monetary policy to achieve that rate.

4.2.2 Instruments of Monetary Policy

Instruments of monetary policy are the tools with the RBI that can be used to realise its set targets and objectives. For the RBI, the various instruments of monetary policy are Repo Rate, LAF (Liquidity Adjustment Facility), Open Market Operations (OMOs), CRR (Cash Reserve Ratio), SLR (Statutory Liquidity Ratio) etc. Repo and Reverse Repo Operations, Marginal Standing Facility, Term Repo and Variable Rate Repo and Reverse Repo etc. are the major tools of liquidity management. These instruments are divided into Direct and Indirect instruments depending upon the way they work and influence the targets.

4.2.2.1 Direct Instruments

The direct instruments are those instruments of monetary policy which enable the RBI to hit the monetary policy targets (money supply, liquidity) without significant policy action by others. The direct instruments are Cash Reserve Ratio, Statutory Liquidity Ratio and Refinance Facilities.

a. **Cash Reserve Ratio (CRR):** The average daily balance that a bank is required to maintain with the Reserve Bank as a share of such of its Net Demand and Time Liabilities (NDTL). By varying the cash reserve ratio, the central bank can vary the volume of credit in the economy. If CRR is decreased, banks can give a higher amount of loans as they have to keep fewer reserves with the RBI. When the CRR is increased the banking system's credit creation capacity comes down with immediate effect. There is no time lag involved in the deployment of CRR.

Net Demand and Time Liabilities (NDTL) - refers to the total demand and time liabilities (deposits) of the public that are held by the banks with other banks.

b. **Statutory Liquidity Ratio (SLR):** The share of NDTL that a commercial bank is required to maintain in safe and liquid assets, such as unencumbered government securities, cash and gold. Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.

Difference between CRR and SLR: CRR is the proportion of the deposits kept with RBI, SLR is the proportion of the deposit kept with the bank itself in the form of liquid assets.

c. **Refinance Facilities:** Sector-specific refinance facilities given by the RBI to banks. The main type of refinance facilities is those given to the export sector through banks. Export refinance facilities include foreign exchange, swap facility etc., offered by the RBI.

4.2.2.2 Indirect Instruments

Indirect instruments are the instruments of RBI where policy actions or responses in institutions like commercial banks are also necessary for hitting the target and objectives set by the RBI. Indirect instruments are Repo Rate, Reverse Repo Rate, Liquidity Adjustment Facility, Open Market Operations, MSF, Market Stabilisation Scheme, Rupee-Dollar Swap Facilities, Term Repo, Long Term Repo Operations (LTROs), Targeted Long Term Repo Operations (TLTROs), Corridor and Bank Rate.

a. **Repo Rate**: The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the liquidity adjustment facility (LAF). In simple terms Repo, 'Repurchasing Option' is a contract in which the commercial bank pledge securities such as treasury bills with the RBI while availing an overnight loan. There is a commitment to buy back the securities at a specified time and price simultaneously with the repayment of the loan. Repo is an instrument of liquidity injection, i.e. the RBI injects liquidity into the system.

   Repo rate is the interest rate charged by the RBI on overnight loans given to the commercial banks under the liquidity adjustment facility. The overnight fixed repo on daily basis was withdrawn by RBI in February 2020. The RBI is now using other variants of repo like long-term repo as a part of the new liquidity framework.

   With an increase in repo rate, commercial banks usually raise the rates at which they extend loans to the borrowers. For consumers, the loans become more costly, which further move into higher costs for homes, automobiles and other commodities. A lower rate means loans from banks become cheaper for corporate borrowers as well as individuals for funding houses, automobiles and other purposes. To ensure the benefits of lower rates are passed on to the borrowers, the RBI has asked banks to link their lending rates to an external benchmark like the repo, which has been chosen by most banks.

b. **Reverse Repo Rate:** The fixed interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF. It is a facility under the LAF where banks can park their excess money with the RBI for a single day while getting an interest rate called reverse repo rate. It is the interest rate that the RBI gives to banks by accepting one-day funds from them. Reverse repo is aimed for liquidity absorption by RBI when the banking system is having excess liquidity.

c. **Liquidity Adjustment Facility (LAF)**: The LAF consists of overnight as well as term repo auctions. It is a collective arrangement that includes several

liquidity tools by the RBI to manage liquidity in the financial system. LAF is the mechanism by the RBI through which the central bank supports the liquidity needs of the commercial banking system. Both liquidity injection and liquidity absorption are made by the RBI through various instruments including short-term loans (like term repo for 1 to 13 days), auction etc. Liquidity absorption is the opposite activity where the central banks receive excess funds from the banking system by giving an interest rate.

d. **Marginal Standing Facility (MSF)**: A facility under which scheduled commercial banks can borrow additional amounts of overnight money from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit at a penal rate of interest. It is an overnight loan facility provided by the RBI to banks when the latter does not have a sufficient level of eligible securities to get loans under repo. It is basically an emergency liquidity facility. MSF permits banks to borrow overnight from the RBI by submitting a prescribed amount of securities to RBI when the banks do not have eligible securities. They can borrow up to a prescribed limit, but for this, they should give a higher rate of interest. The rate of interest under MSF will be higher than the repo rate. MSF will be undertaken in all SLR eligible transferable Government of India dated securities/treasury bills and State Development Loans (SDL). The RBI has the right to accept or reject partially or fully, the request for funds under this facility.

Corridor: The MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate. It is the area between MSF and the reverse repo rate. Ideally, the call rate should travel between the corridor and this shows a comfortable liquidity situation in the system.

MSF is the upper ceiling of the corridor and the reverse repo is the lower ceiling. The call rate should move within the corridor. The repo rate is usually placed in the middle of the corridor. Corridor shows the position of the call rate, which is the operating target of monetary policy.

e. **Bank Rate:** It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. The Bank Rate is published under Section 49 of the Reserve Bank of India Act, 1934. This rate has been aligned to the MSF rate and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.

f. **Open Market Operations (OMOs):** These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively. Buying securities by the RBI in the open market increases the liquidity in the market. On the other hand, selling securities reduces the liquidity in the system. When securities are sold, the financial institutions buy them and the RBI gets an equivalent volume of money. In this way, money supply or liquidity comes down in the financial system. Securities sold and purchased are government securities including bonds and treasury bills.

Operation Twist: This is an exercise carried out by RBI in 2019 to bring down long term interest rates in the economy. It sold short term government securities, maturing in 2020 and simultaneously bought long term securities, maturing in 2029 through special OMOs.

g. **Market Stabilisation Scheme (MSS):** It is an open market operation by the RBI aimed to sterilise or withdraw the excess money supply created out of the foreign exchange market intervention by the RBI. This instrument for monetary management was introduced in 2004. The stabilisation through withdrawal of excess money supply is done by issuing Market Stabilisation Bonds to financial institutions. The cash so mobilised is held in a separate government account with the Reserve Bank.

Foreign capital inflow flooded the foreign exchange market and thus caused an appreciation of the domestic currency. Too much appreciation is undesirable as it often reduces exports and increases imports and thus worsen the trading account. So, during high appreciation, the RBI buys foreign exchange to check appreciation. In the process, it releases an equivalent volume of domestic currency while purchasing foreign currency. This causes the expansion of the domestic money supply which should be withdrawn; otherwise, it may produce inflation. For this purpose the central bank launched the program of sterilisation. Sterilisation in the context of the monetary policy refers to the activity of the central bank in taking away the excess money supply created due to its foreign exchange market intervention.

Market Stabilisation Bonds: These are Government bonds provided by the Central Government to the RBI for the dedicated purpose of removal of excess liquidity under the MSS. Market Stabilisation Bonds are government securities (bonds, T bills and Cash Management Bills) issued by the RBI to withdraw the excess liquidity.

h. **Term Repo:** It is a liquidity injection instrument by the RBI where it auctions a given amount of funds of a specified tenure (1 day to 13 days) to the entire banking system. It is often described as a 'Variable Rate Term Repo'. Its interest rate is determined through an auction. A cut off rate above the repo rate is set for the auction. This means that a bank should offer an interest rate above the repo rate.

i. **Long Term Repo Operations (LTRO):** The RBI launched a new facility in the form of Long-Term Repo Operations to supplement the liquidity in the banking system on February 6, 2020. The purpose of LTRO is to facilitate monetary transmission such that banks should get durable liquidity at a reasonable cost in the context of prevailing market conditions. They are repo operations conducted for the long term like one year to three years, offering funds to banks at the prevailing repo rate.

j. **Targeted Long-Term Report Operations:** Targeted long term repo operations are long term repo operations conducted by the RBI to ensure adequate liquidity at a longer period for specific sectors. Under this programme, the RBI will provide funds to the banks so that the latter can invest in securities of entities in the specifically targeted sector like corporate, NBFCs and HFCs etc. The amount will be auctioned for 1 to 3 years and the interest rate will be a floating rate linked with the repo rate.

k. **Dollar Rupee Swap Facility:** The dollar rupees swap facility is a liquidity facility by the RBI where the central bank provides either dollar liquidity or rupee liquidity by accepting the opposite currency. The liquidity is provided to selected institutions, mainly commercial banks. The implication of the swap is that if the RBI sells dollars to the institutions today, they have to return the dollar at the end of the swap period. The opposite happens when the RBI buys dollars.

The instruments of monetary policy or methods of credit control are divided into two types:

1. General or Quantitative methods
2. Selective or Qualitative methods

4.2.2.3 General or Quantitative Methods

General or quantitative methods affect the total volume of credit. It includes Bank Rate Policy, Open Market Operations, Cash Reserve Ratio, Statutory Liquidity Ratio etc,.

1. **Bank Rate Policy: T**he bank rate is the minimum lending rate of the central bank at which it rediscounts first-class bills of exchange and government securities held by the commercial banks. When the central bank finds that inflationary pressures have started emerging within the economy it raises the bank rate. Borrowings from the central bank become costly and commercial banks borrow less from it. The commercial banks, in turn, raise the lending rates to the business community and borrowers borrow less from the commercial bank leading to a contraction of credit and prices are checked from rising further. On the other hand, when prices are depressed, the central bank lowers the bank rate. It is cheaper to borrow from the central bank and from the commercial banks. Businessmen are encouraged to borrow, more investment increases output, employment, income and demand start rising and the downward movement of prices is checked.

2. **Open Market Operations:** Open market operations refer to the sale and purchase of securities in the money market by the central bank. When prices are rising, the central bank sells securities. The resources of commercial banks are reduced and they are not in a position to lend more to the business community, further investment is discouraged and the rise in prices is checked. Contrarily, when recessionary forces start in the economy, the central bank buys securities. The reserves of commercial banks are raised, they lend more. Investment, output, employment, income and demand rise and fall in price is checked.

3. **Changing the Reserve Ratios:** This method was suggested by Keynes and the USA was the first to adopt it as a monetary device. Every bank is required to keep a certain percentage of its total deposits in the central bank and also within the banks. When prices are rising the central bank raises the reserve ratio. The banks are required to keep more with the central bank. Their reserves are reduced and they lend less. The volume of investment, output and employment were adversely affected. When the reserve ratio is lowered, the reserves of the commercial banks are raised and their lending capacity increases which favourably affects economic activity.

4.2.2.2 Qualitative or Selective Instruments

Selective or qualitative methods affect specific sectors and segments of the economy. Minimum margins for lending against specific securities, ceiling on volume of credit for certain purposes, discriminatory rates of interest etc. are examples of selective credit control.

1. **Moral Persuasion or Advice:** The central bank gives advice to other banks, on moral grounds, about the credit control and therefore objectives and need of the money supply and by publishing and analysing the statistics about the dangerous consequences of credit expansion, so that it may seek the cooperation of the commercial banks in coping with the situation of economic emergency.

2. **Rationing of Credit:** The maximum limit of taking loans from the central bank is decreased for those commercial banks which do not cooperate with the central bank in controlling the credit and the central bank also gives loans to such banks at a higher bank rate. This method of credit control has become very popular in Germany and is used nowadays by almost all countries.

3. **Direct Action:** When some commercial banks do not cooperate with the central bank in controlling the credit then the central bank has to take some direct action against such banks. Sometimes the central bank refuses to give loans or discount the bills of exchange of the commercial banks and sometimes the central bank starts imposing some extra fines other than the rates of discounting on the commercial bank. Due to this the reputation of the commercial bank and also their business is affected badly in the market.

4. **Changes in the Margin Requirements:** The banks give loans by mortgaging some stocks with them. This loan is not equal to the stock mortgaged, but less than that. The central bank gives orders as to how much should be the margin requirements; i.e. what percentage of the total stock mortgage should be given in the form of loans. A higher margin requirement means the loan should be much less than the value of the stock. When the credit is to be controlled the central bank decreases the amount of loan given against the securities or increases the margin requirements.

Recap

- Monetary Policy regulates money supply and bank credit
- Classical economists emphasised monetary policy, while Keynes focused on fiscal policy during depression periods
- After 1960, monetary policy regained importance due to inflation concerns in countries like the US and the UK
- Monetary policy involves managing interest rates, money supply, and credit availability to influence economic activities
- Objectives of monetary policy: 1) Price stability, 2) Adequate credit flow to productive sectors, 3) Financial stability
- Inflation targeting has become the central strategy to control inflation rates
- Direct instruments: Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), Refinance Facilities
- Indirect instruments: Repo Rate, Reverse Repo Rate, Liquidity Adjustment Facility (LAF), Open Market Operations (OMOs), Marginal Standing Facility (MSF), Bank Rate, Corridor
- Repo Rate is the rate at which RBI lends to banks; Reverse Repo Rate is the rate for absorbing excess liquidity
- Open Market Operations control liquidity by buying and selling government securities
- Bank Rate and MSF help manage liquidity in the financial system
- Liquidity Adjustment Facility (LAF) helps balance liquidity in the banking system, including term repos and auctions

Objective Questions

1. What is the primary responsibility of the RBI in monetary policy?
2. Who is credited with the idea that fiscal policy is more important than monetary policy during economic depressions?
3. What is the main objective of the RBI according to the amended RBI

Act 1934?

4. What is the tool used by the RBI to control inflation through regulating interest rates?

5. Which policy is primarily concerned with the regulation of money supply and bank credit?

6. What was the main problem faced by countries like America and England after 1960?

7. In which year was the RBI Act amended to include the objective of inflation targeting?

8. What does CRR stand for?

9. What does SLR stand for?

10. Name direct instrument of monetary policy used by the RBI.

11. What is the process through which the RBI injects liquidity into the banking system through the purchase of government securities?

12. What is the interest rate at which the RBI borrows from commercial banks overnight against government securities?

13. What is the interest rate called that the RBI offers to commercial banks for overnight funds under the Liquidity Adjustment Facility?

14. What is the overnight loan facility provided by the RBI at a penal rate of interest called?

15. What does the "corridor" refer to in the context of RBI's monetary policy?

16. What is the facility under which banks can borrow money from the RBI when they do not have eligible securities?

17. Which monetary policy tool is used by the RBI to manage liquidity in the financial system through auction mechanisms?

18. What is the RBI's interest rate on rediscounting commercial bills called?

19. What is the policy of adjusting the money supply by purchasing or selling government securities in the open market?

20. What does the MSF rate determine?

Answers

1. Regulate money supply
2. J.M. Keynes
3. Price stability
4. Repo Rate
5. Monetary Policy
6. Inflation
7. 2016
8. Cash Reserve Ratio | SLR | Reference facilities
9. Statutory Liquidity Ratio
10. Cash Reserve Ratio
11. Open Market Operations
12. Repo Rate
13. Reverse Repo Rate
14. Marginal Standing Facility
15. The range between MSF and Reverse Repo Rate
16. Marginal Standing Facility
17. Liquidity Adjustment Facility
18. Bank Rate
19. Open Market Operations
20. Upper ceiling of the corridor

Assignments

1. Discuss the evolution of monetary policy.
2. Explain the major objectives of monetary policy.
3. Elaborate on the various direct and indirect instruments of monetary policy.
4. Describe the liquidity adjustment facility provided by RBI.
5. What do you mean by Selective Credit Control Measures? Explain.

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UNIT 3

Banking Sector Reforms in India

Learning Outcomes

After completing this unit, learners will be able to:

- understand the evolution of the banking sector in India
- learn the various reforms in the banking sector
- discuss various objectives of reforms in the banking sector
- know the Narasimham Committee report and its recommendations

Prerequisites

Like many other aspects, we have a long tradition of banking. Evidence regarding the existence of money lending operations in India is found in the Vedic time literature, i.e., 2000 to 1400 B.C. The literature of the Buddhist period, e.g., the Jatakas, and recent archaeological discoveries supply evidence of the existence of 'Sresthis', or bankers. From the laws of Manu, money lending and allied problems had assumed considerable importance in ancient India. Chanakya, gives a different approach. The interest rate works out to be 15 per cent per annum for general advances. The traders are charged a rate of 60 per cent per annum. The present banking system following in our economy has its roots from the ancient period and still exists in the present economy. This unit explores the origin and evolution of the banking system in our country and sectoral reforms taken place to overcome the difficulties in it.

Keywords

Financial Reforms, Nationalisation, Banking Crisis, Narasimham Committees, Deregulation, NPA, PSB, Banking Efficiency, Asset Securitisation

Discussion

4.3.1 Banking Sector Reforms in India

Financial sector in India is dominated by commercial banks. Their assets size is larger than that of other types of financial institutions. The banking system in the country performs exceptional financial intermediation in different ways. They mobilise savings from the public, provide loans, and invest in government securities and thus channel funds to the government, assist in development schemes and programmes, support financial inclusion and also transmits monetary policy. In India, the commercial banking sector comprises public banks (SBI, Nationalised banks), private banks, and foreign banks. It evolved into the present status and structure after undergoing a big evolution phase.

After Independence, two important phases have configured the present banking industry: the nationalisation of 1969 and 1980 and the banking sector reforms since the mid- 1990s.

4.3.1.1 History of Banking Sector Reforms in India

Beginning of Banking in India: The early phase of banking in India- up to 1947

The early eighteenth century laid the foundation of the Indian banking system. The Bank of Hindustan (Calcutta) was the first bank established in India and was created in 1770 by an agency house. In 1806, the East India Company established the Presidency Bank in Bengal. Two more banks were established in 1840 and 1843 named Bank of Bombay and Bank of Madras. The first Indian owned bank was the Punjab National Bank set up in 1895 in Lahore. Bank of India was established in 1906 in Mumbai. These banks were founded under private ownership. Several Indian commercial banks such as the Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank and Bank of Mysore were established between 1906 and 1913. By the end of 1930, the total number of reporting commercial banks in the country reached 56.

The Bank of Bengal, Bank of Mumbai and Bank of Madras were amalgamated to form a single bank under the name. The Imperial Bank of India in 1921. The Imperial Bank of India functioned as the central bank before the establishment of RBI in 1935. Reserve Bank of India (RBI) was established on April 1, 1935, with the enactment of the Reserve Bank of India Act, 1934. The main objective of establishing the Reserve Bank, as stated in the preamble to the RBI Act, was to "regulate the issue of banknotes and the keeping of reserves with a view of securing monetary stability in India".

Post-Partition Consolidation and RBIs Emergence as a Regulator (1947 to 1967)

During the time of independence, Indian banking was entirely in the private sector. Even the RBI was also not completely state-owned until it was nationalised in 1949. Partition of the nation deeply hurt the banking system as well. Many of the banks in the states of Punjab and West Bengal were severely affected due to the partition. In the very next year, 45 relatively larger banks were closed down. To check the adverse trends, the government enacted Banking Companies Act, 1949 later renamed as the Banking Regulation Act. The Act conferred extensive powers to the RBI for banking supervision as the country's central banking authority. Even after the Banking Companies Act, bank failures continued. Then the government amended the Banking Regulation Act in 1960. The amendment was aimed to facilitate expeditious payment to the depositors during bank liquidation and empowered the government and the RBI with additional powers to rehabilitate banks in difficulties. To ensure the safety of deposits, the Deposit Insurance and Credit Guarantee Corporation Act was enacted in 1961. The major development in the post-independence period was the nationalisation of the Imperial Bank of India into the State Bank of India in 1955.

Social Control Over Banks (1967 to 1991) and the Spread of Banking

The time period from 1967 can be described as a period of 'Social Banking'. Social banking simply refers to the way of delivering banking functions with a social purpose like serving the unserved segments and providing loans at a concessional rate to the weaker section. Priority Sector Lending (1969), Lead Bank Scheme (1969), Service Area Approach (1989) etc. were launched and later Regional Rural Banks and Local Area Banks were created to deliver social and economic development activities by the banking system.

Priority Sector Lending is the role exercised by the RBI so that banks can dedicate funds for specific sectors of the economy like agriculture and allied activities, education and housing and food for the poorer population.

Lead Bank Scheme is a scheme which aims at providing adequate banking and credit in rural areas through a 'Service Area Approach', with one bank assigned for one area.

Nationalisation of Banks

The government nationalised 14 commercial banks in 1969 and 6 banks in 1980 to facilitate social banking. The Indian banking system has undergone a major structural transformation after the nationalisation. There were two defining features of the Indian banking sector after nationalisation. First, most of the banks came under government control and second, several social and economic development programmes were implemented under the banking network.

Pre-Reform Features of the Banking Sector and Banking Sector Crisis

Social banking produced some desirable effects on the development side of the

economy and at the same time, it left some undesirable effects on the collective health of the banking system. High SLR compelled the banks to invest a sizable portion of the deposits in government securities. Adding to these restrictions, there was no entry for new banks. This resulted in a non-competitive environment in the banking system. Opening the rural branches also increased the cost for banks. Major indicators of the bank's health such as interest income declined and the level of NPAs soared towards the early 1990s. The net result of these factors was reflected in the poor financial performance of banks. The quantity of bank credit was affected by CRR and SLR whereas the quality of bank credit was affected by priority sector lending and administrative interest rate regime. Thus, poor profitability and the high proportion of NPAs of PSBs led them towards a crisis by 1990.

In this context a systematic correction in the banking sector became necessary and it started with the appointment of a committee on the financial sector by the Ministry of Finance under the chairmanship of M. Narasimham. In the 1990s, Narasimham took two remarkable steps for the restructuring of the banking sector by chairing committees; the first was in 1991 called the Committee on Financial Sector and the second was Committee on Financial Sector Reforms in 1997. The committee was responsible for making recommendations for the entire financial systems, the main focus was the banking sector.

4.3.2 Objectives of Banking Sector Reforms

The key objective of reforms in the banking sector in India has been to enhance the stability and efficiency of banks. To achieve this objective various reform measures were initiated that could be categorised broadly into three major groups: Enabling Measures, Strengthening Measures and Institutional Measures.

Enabling measures were designed to create an environment where banks could respond optimally to market signals on the basis of commercial considerations. Among these included reduction in statutory pre-emptions so as to release greater funds for commercial lending, interest rate deregulation to enable price discovery, granting of operational autonomy to banks and the liberalisation of the entry norms for financial intermediaries.

The strengthening measures aimed at reducing the vulnerability of banks in the face of fluctuations in the economic environment. This included capital adequacy, income recognition, asset classification and provisioning norms, exposure norms, improved levels of transparency and disclosure standards.

Institutional framework for the development of banks. Salient among these include reforms in the legal framework pertaining to banks and the creation of new institutions.

4.3.2.1 The Narasimham Committee on Financial Sector (CFS 1992)

The committee made several life changing recommendations on the banking sector. That includes removing the restrictions on new bank licences, removing the administrative interest rate regime, reducing both the CRR and SLR etc.

1. Deregulation of Entry: There should be no bar on the entry of new banks in the private sector provided they fulfil the startup capital and other requirements prescribed by the RBI.

2. There should be a phased reduction of CRR, and SLR should be phased out.

3. The interest rate shall be deregulated. Banks themselves should determine interest rates.

4. No More Nationalisation: The government should indicate that there would not be further nationalisation of banks. Similarly, there should not be any difference in the treatment between public sector banks and private sector banks.

5. The banking sector should evolve towards a broad pattern consisting of three or four large banks including the SBI, which would become international; 8 to 10 national banks with the branch network throughout the country engaged in universal banking and local banks whose operation would be focused in a specified region and lastly, rural banks to serve rural areas.

6. Asset Securitisation to Cover the NPAs: An Asset Reconstruction Fund (ARF) shall be formed to take over bad debts from the banks and financial institutions. The public sector banks and financial institutions should subscribe to the capital of ARF.

7. Creation of Debt Recovery Tribunals: The banks and the financial institutions should be authorised to recover bad debts through special tribunals.

8. The public sector banks with profitable operations should be allowed to tap the capital market for the enhancement of their share capital. Subscribers to such issues could be mutual funds, profitable public sector undertakings and institution's employees besides the general public.

9. Delicensing of Branch Expansion: Branch licensing should be abolished and the option for starting branches should be given to the individual judgements of the commercial banks.

10. A liberal approach should be adopted for allowing foreign banks in the country. Both foreign and domestic banks should be treated equally.

11. Reduction in Priority Sector Lending: Priority sector targets for credit should be redefined in such a that it should not be more than 10% of the total credit.

12. The dual control of RBI and the Finance Ministry on banks should be abolished and RBI only should function as a regulatory authority.

13. RBI representatives should not be included in banks management boards only government representatives should be there.

14. On DFIs (Development Financial Institutions): Granting resources to Developmental Financial Institutions on concessional interest rates should be abolished in the next 3 years.

4.3.2.2 Narasimham Committee 2: Banking Sector Reforms (CFSR 1998)

The second phase of reforms place a greater emphasis on structural measures and improvement in standards of disclosure and the levels of transparency in order to align the Indian standards with international best practices. In its second term, the Narasimham committee reviewed ongoing reforms in the financial sector and made further correction measures.

1. A Merger of Strong Banks: A merger of strong banks will have a multiplier effect on the banking industry. The committee cautioned against the merger of strong banks with weak banks. This will adversely affect the financial health and asset quality of solid banks.

2. The practice of narrow banking should be tried to rehabilitate weak banks. If this is not successful, closure of the bank can be examined. Narrow banking means banks are investing a high proportion of their funds in government securities.

3. International Banks: Two or three large Indian banks should be given global size and character.

4. Small and local banks should concentrate in states or clusters of districts to serve local trade, small industry, and agriculture.

5. The committee also commented on the Government's role in public sector banks by observing that, government ownership that has become an instrument of bank management is not calculated to enhance autonomy and flexibility.

6. Functions on the board and management need to be reviewed so that boards remain responsible for enhancing shareholder's value through a corporation or corporate strategy.

7. Need to review minimum prescriptions for capital adequacy.

8. RBI Act, Bank Nationalisation Act, Banking Regulation Act and State Bank of India Act are in urgent need of review.

9. Integration of NBFCs lending activities into the financial system.

10. Review of requirement procedures, training and remuneration policies in public sector banks.

11. Need for professionalising and depoliticising of the bank boards.

4.3.2.3 Impacts of Banking Sector Reforms

Among all reform measures that have been adopted in different sectors from the early 1990, the financial sector reforms were sound and extensive. India's banking

system emerged as stable, well-regulated and sophisticatedly supervised as a result of the reforms. The reform measures are still going on with the creation of differentiated banks and the restructuring and consolidation of Public Sector Banks (PSBs).

1. Health, solvency, and efficiency of the banking sector were ensured through the adoption of prudential regulation.

2. Market orientation- interest rate, entry and banking products etc were made market oriented.

3. Easy liquidity: there was more liquidity with the banking sector as a result of the reduction of CRR and SLR; more funds were available with the commercial banks for lending.

4. Soft interest rate regime: deregulation of the interest rate- banks now have autonomy to set their own interest rate (base rate) in accordance with the repo rate.

5. Profitability of the banks improved as a result of financial sector reforms due to reduction of SLR, reduction of CRR, abolition of the administered interest rate regime etc.

6. Enhanced competition has taken place due to the relaxation of entry norms and rapid restructuring of the financial sector and the internal structure within the banking system. The entry of new generation banks, private sector banks and the foreign banks have helped the competitive environment.

7. Diversification of more money market instruments was introduced as a part of reforms.

8. More deepening of the financial sector: reduction in SLR and CRR have helped banks to extend more loans in competitive, market-oriented segments like housing finance.

9. Autonomy to PSBs: autonomy has been given to PSB boards subject to conditions. No more political intervention and disinvestment will be done by keeping 51% government shareholding.

10. Banks are making financial innovation in the context of technological development: the use of core banking, cheque transactions, online banking etc have transformed the way banks deliver their functions.

4.3.2.4 Challenges for the Banking Sector

The Indian banking system is currently passing through a crucial phase. Although the banking sector has become strong, competitive, dynamic and resilient, it is faced with several newer challenges as a result of macroeconomic and financial sector developments, both domestic and global. The major issues or challenges faced by the Indian banking sectors could be identified as follows:

- Emergence of financial conglomerates, which has raised the issue of appropriate regulatory structure or arrangement.
- Emergence of complex financial products which pose several supervisory challenges.
- Need to extend financial services to the large number of people who continued to remain outside the banking system.
- Mobilising resources to sustain and even accelerate the current economic growth momentum.
- Issues involved in allowing increased presence of foreign banks in India.
- Progressive moves towards fuller capital account convertibility which will expose the banking system to greater risk and would require addressing certain issues in the banking, including some regulatory and supervisory aspects.

To sum up, the banking sector reforms introduced in the early 1990 in a gradual and sequenced manner were directed at the removal of various deficiencies from which the system was suffering. The basic objectives of the reforms were to make the system more stable and efficient so that it could contribute to accelerating the growth process. The banking sector reforms have supported the transition of the Indian economy to a higher growth path while significantly improving the stability of the financial system.

Recap

- The banking sector in India is dominated by commercial banks, with assets larger than other financial institutions
- Indian banking evolved post-independence, with key phases being nationalisation (1969, 1980) and reforms from the 1990s
- Early banking in India began in the 18th century, with major banks established in the 19th century
- RBI was established in 1935 and nationalised in 1949
- The 1969 nationalisation aimed to promote social banking and financial inclusion
- The banking sector faced a crisis in the 1990s due to high NPAs, poor profitability, and limited competition
- The Narasimham Committees (1991, 1997) recommended reforms like deregulation of entry, asset securitisation, and reduced CRR/SLR
- The second Narasimham Committee (1998) emphasised structural reforms and improved disclosure standards
- Reforms enhanced the stability, efficiency, and competitiveness of Indian banks
- Ongoing reforms aim at creating differentiated banks and consolidating public sector banks (PSBs)

Objective Questions

1. Which was the first bank established in India?
2. In which year was the RBI established?
3. Which Act conferred extensive powers to the RBI for banking supervision?
4. Which year did the government nationalise 14 commercial banks?
5. What is the key objective of the banking sector reforms in India?

6. What was the name of the first Indian-owned bank?
7. Which bank became the State Bank of India (SBI) after nationalisation?
8. Which Act governs the banking regulation in India?
9. In which year was the Banking Regulation Act amended to facilitate expeditious payments to depositors?
10. Which committee is known for making significant recommendations on banking sector reforms in 1991?
11. Which committee reviewed the ongoing banking sector reforms in 1998?
12. What is the full form of CRR?
13. What does SLR stand for?
14. What was the name of the first bank established by the East India Company?
15. What is the key focus of the Narasimham Committee on Financial Sector Reforms (1997)?
16. What does 'social banking' refer to in the context of the Indian banking sector?
17. Which scheme aimed to provide adequate banking and credit in rural areas by assigning one bank per area?
18. Which Act established the Deposit Insurance and Credit Guarantee Corporation?
19. Which bank was nationalised into the State Bank of India in 1955?
20. Which sector does Priority Sector Lending target in the banking sector?

Answers

1. The Bank of Hindustan
2. 1935
3. Banking Regulation Act, 1949
4. 1969

5. To enhance the stability and efficiency of banks
6. Punjab National Bank
7. Imperial Bank of India
8. Banking Regulation Act, 1949
9. 1960
10. Narasimham Committee on Financial Sector, 1991
11. Narasimham Committee 2, 1998
12. Cash Reserve Ratio
13. Statutory Liquidity Ratio
14. Presidency Bank of Bengal
15. Improvement in standards of disclosure and structural measures
16. Delivering banking functions with a social purpose
17. Lead Bank Scheme
18. The Deposit Insurance and Credit Guarantee Corporation Act, 1961
19. Imperial Bank of India
20. Agriculture and allied activities, education, housing, food for the poor

Assignments

1. Elucidate the evolution of the Banking sector in India.
2. Briefly explain the history of Banking sector reforms in India.
3. Critically examine various recommendations of Narasimham Committee 1992.
4. Discuss the second phase of Banking Sector reforms in India.

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Financial Market 1

UNIT 1 Banks and NBFIs

Learning Outcomes

After completing this unit, the learner will be able to:

- get a basic understanding of financial markets
- recognise and understand types of the financial market
- know the role and importance of the financial market
- understand the functioning of financial markets

Prerequisites

Centuries ago, barter was the only mode of exchange for goods and services. Then came commodity money followed by fiat money and the M1, M2, and M3 measures of money. Rapid industrialisation and the exponential growth in business and trade resulted in the need for more capital for further businesses. The government wants to raise money to sustain its growth.

Banks and financial markets have evolved in this ecosystem, primarily to channel money from those who have it (savers/investors) to those who need it (borrowers). The expansion of the banks and the financial markets deepened in size, sophistication and complexity over the years.

Keywords

Financial System, Banks, Non-Banking Financial institutions, Financial Assets

Discussion

5.1.1 Financial System

In a broad sense, finance refers to funds or monetary resources needed by individuals, business firms and the government. Individuals need money to meet their day-to-day activities. Business firms need funds for paying wages, and salaries, buying raw materials, purchasing new machinery etc. The government needs funds to meet its expenditure on goods and services and finance its developmental programmes.

5.1.1.1 Meaning

Everyone transacts with money on a day-to-day basis. The financial system provides a mechanism where any firm or lender may conveniently make funds available to borrowers who intend to spend more than their current income. A financial system may be defined as "a set of institutions, instruments and markets which foster savings and channel them to their most efficient use". The financial system enables lenders and borrowers to exchange funds. India has a financial system that is controlled by regulators in the sectors of insurance, banking, capital markets and various sectors. Thus, a financial system can be said to play a significant role in the economic growth of a country by mobilising surplus funds and them effectively for productive purposes.

The financial system of a country consists of financial instruments and financial services. It is very important in allocating capital. Thus it provides a base for the continuous reorganisation of the economy which is needed for growth.

5.1.1.2 Features

The features of financial system are:

- It plays a major role in the economic development of a country.
- It encourages both savings and investment.
- It links savers and investors.
- It helps in capital formation.
- It helps in the allocation of risks.
- It facilitates the expansion of financial markets.

5.1.1.3 Components

The main components of financial system are:

1. Financial Institutions

2. Financial Markets

3. Financial Instruments/ Assets/ Securities

4. Financial Services.

These are the four major components of the Indian financial system

1. Financial Institutions

Financial institutions are firms which provide financial services to lenders and borrowers. They are the intermediaries who facilitate the smooth functioning of the financial system by making investors and borrowers meet. They savings of the surplus units and allocate them to productive activities promising a better rate of return. Financial institutions also provide services to entities (individuals, business firms, government) seeking advice on various issues ranging from restructuring to diversification plans. They provide a wide range of services to entities who want to raise funds from the markets or elsewhere.

Financial institutions are also termed financial intermediaries because they act as middlemen between savers and borrowers, by accumulating funds from one and by lending these funds to the other.

2. Financial Market

The financial market is the place where financial assets were are transferred. A financial market may be defined as, "a market which is an aggregate of possible buyers and sellers of financial securities, commodities and other fungible items as well as the transaction between them". It means the flow of investment from savings. They are the centres which provide the facility for buying and selling financial instruments. It is a part of the financial system of an economy.

3. Financial Instruments/ Financial Assets

Financial instruments refer to those documents which represent financial claims on assets. Financial asset refers to a claim to the repayment of a certain sum of money at the end of a specified period together with interest or dividend. Examples: bill of exchange, promissory note, treasury bill.

4. Financial Services

The term financial services can be defined as "activities, benefits, and satisfactions, connected with the sale of money, which offer to users and customers, financial related value.

Within the financial services industry, the main sectors are banks, financial institutions, and non-banking financial companies.

5.1.2 Financial Institutions

Financial Institutions can be classified into two categories:

- Banking Institutions
- Non-Banking Institutions

5.1.2.1 Banking Institutions

The Indian banking industry was controlled by the monetary authority, the RBI. The Indian banking institutions can be broadly classified into two categories:

- Organised Sector
- Unorganised Sector.

1. Organised Sector

The organised banking sector consists of Commercial banks, Cooperative banks and Regional Rural banks.

a. **Commercial Banks:** The commercial banks may be scheduled banks or non–scheduled banks. The commercial banks consist of public sector banks, private sector banks and foreign banks. Prior to 1969, all major banks with the exception of the State Bank of India, are in the private sector. An important step towards public sector banking was taken in July 1969, when 14 major private banks with a deposit base of 50 crores or more were nationalised. Later in 1980, another 6 were nationalised bringing up the total number of banks nationalised to twenty.

b. **Co-operative banks**: An important segment of the sector of Indian banking is co-operative banking. The segment is represented by a group of societies registered under the Acts of the states relating to cooperative societies. In fact, co-operative societies may be credit societies or non-credit societies. Different types of cooperative credit societies are operating in the Indian economy. These institutions can be classified into two broad categories: Rural Credit Societies and Urban Credit Societies with their primary focus respectively on agriculture and non-agriculture.

c. **Regional Rural Banks (RRBs):** Regional Rural Banks were set by the state government and sponsoring commercial banks with the objective of developing the rural economy. Regional rural banks provide banking services and credit to small farmers and small entrepreneurs in rural areas. The regional rural banks were set up with a view to providing credit facilities to weaker sections. They constitute an important part of the rural financial architecture in India.

d. **Foreign Banks:** Foreign banks have been in India since the British days. Foreign banks as banks that have branches in other countries and the main headquarter in the home country. With the deregulation (elimination of government authority) in 1993, a number of foreign banks are entering India. Examples: Citi Bank. Bank of Ceylon.

2. Unorganised Sector

The unorganised banking sector in India consists of the indigenous bankers, and money lenders.

a. **Indigenous Bankers:** Indigenous Bankers are private firms or individuals who operate as banks and as such both receive deposits and give loans. Like bankers, they are also financial intermediaries. They should be distinguished professional money lenders whose primary business is not banking and money lending. The indigenous banks are trading with the hundies and commercial paper.

b. **Money Lenders:** Money lenders depend entirely on their own funds. Money lenders may be rural or urban, professional or non-professional. They include a large number of farmers, merchants, and traders. Their operations are entirely unregulated. They charge a very high rate of interest.

5.1.2.2 Non–Banking Institutions

The non–banking institutions may be categorised broadly into two groups:

a. Organised Non–Banking Financial Institutions.

b. Unorganised Non–Banking Financial Institutions.

a. **Organised Non–Banking Financial Institutions:** The organised non-banking financial institutions include:

- **Development Finance Institutions**

It includes institutions like IDBI, ICICI, IFCI, IIBI, and IRDC at the all India level. The State Finance Corporations (SFCs), State Industrial Development Corporations (SIDCs) at the state level and Agriculture Development Finance Institutions such as NABARD, LDBS etc. Development banks provide medium and long-term finance to the corporate and industrial sectors and also take up promotional activities for economic development.

- **Investment Institutions**

These include those financial institutions which mobilise savings of the public at large through various schemes and invest these funds in corporate and government securities. These include LIC, GIC, LTT, and mutual funds.

b. Unorganised Non-Banking Financial Institutions

The unorganised non-banking financial institutions include a number of Non -Banking Financial Companies (NBFCs) providing a whole range of financial services. These include hire-purchase consumer finance companies, leasing companies, housing finance companies, factoring companies, Credit rating agencies, merchant banking companies etc. NBFCs mobilise public funds and provide loanable funds.

Recap

- Financial system- set of institutions which promote savings and channel them to their most efficient use
- Financial Institutions: firms which provide financial services
- A financial market is a place where financial assets are transferred
- Financial assets- documents which represent financial claims
- Financial services- activities connected with the sale of money

Objective Questions

1. What do you mean by financial system?
2. Write down two features of the financial system.
3. Note down the components of the financial system.
4. Define financial institutions.
5. Define the financial market.
6. Name the two categories of banking institutions.

Answers

1. Financial system links a set of institutions which foster savings and channel them to their most efficient use
2. Savers and investors help in capital formation
3. Financial institutions, financial market, financial instruments, Financial Services
4. Firms which provide financial services

5. Place where financial assets were transferred
6. Organised sector and unorganised sector

Assignments

1. Briefly explain the financial system, its features and components.
2. Explain banking and NBFI.

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UNIT 2

Financial Intermediaries

Learning Outcomes

After completing this unit, the learner will be able to:

- understand the role of financial intermediaries and their importance
- identify different types of financial intermediaries
- know how financial intermediaries manage risk, create products, and serve customers

Prerequisites

Financial intermediaries act as a link between individuals and organisations that have surplus funds and those who require capital to invest, grow their businesses, or achieve their financial goals. These intermediaries, which include commercial banks, investment banks, insurance companies, pension funds, and mutual funds, provide a wide range of financial services that facilitate the efficient flow of funds between savers and investors. By offering various financial instruments and products, such as deposits, loans, securities, and investment portfolios, financial intermediaries enable individuals and businesses to manage risk, invest in assets, and access capital. Moreover, they play a key role in mobilising savings, allocating resources efficiently, and facilitating economic development. By providing a platform for buying and selling securities, financial intermediaries also help to create liquidity in the financial markets, which is essential for their smooth functioning. Overall, financial intermediaries are essential for the proper functioning of the financial system and the economy as a whole.

Keywords

Insurance companies, Pension funds, Mutual funds, Asset Management Companies

Discussion

5.2.1 Insurance Companies

Insurance is a form of protection against possible risk. It is a method which helps in shifting risk to the insurer in consideration of a nominal cost. The aim of all insurance is to compensate the owner against loss arising from a variety of risks, which he anticipated, to his life, property and business. Insurance allows individuals, businesses and other entities to protect themselves against significant potential losses and financial hardship at a reasonably affordable rate. Insurance is a form of risk management in which the insured transfers the cost of potential loss to another entity in exchange for monetary compensation known as the premium. Life insurance, general insurance, marine insurance, fire insurance, medical insurance etc are different types of insurance.

Insurance companies concentrate on fulfilling the insurance needs of the community both for life and non-life insurance. Insurance companies provide insurance policies which are legally binding contracts for which the policyholder pays an insurance premium. As per the insurance contract, insurance companies promise to pay a specified sum contingent on the occurrence of future events such as death or an accident. The insurance companies are risk bearers. They evaluate the risk and exposure of potential clients. They decide how much coverage the client should receive, how much they should pay for it or whether even to accept the risk and insure them.

Insurance companies have two sources of income: initial underwriting income (insurance premium) and investment income. The significant expense of an insurance company is the payment on the insurance policies. Insurance companies' profits mainly depend upon insurance premium and returns thereof on the one hand and the operating expenses and the cost to insure on the other hand.

Insurance companies work by pooling the risk. Pooling the risk means that a large group of people who want to insure against a particular loss pay their premiums into the insurance bucket or the pool.

5.2.2 Pension Fund

Pension funds are the most important institutional investors and participants in the financial market. A pension fund is any plan, fund or scheme which provides retirement income. It is a fund established by an employer to facilitate and organise the investment of employee retirement funds contributed by the employer and employees. Pension funds are commonly run by some sort of financial intermediary for the company and

its employees, although some larger corporations operate their pension funds in-house. They are providing stimulus to the growth of capital markets.

According to Davis (1995), pension funds may be defined as forms of an institutional investor, which collect, pool and invest funds contributed by sponsors and beneficiaries to provide for the future pension entitlements of beneficiaries.

5.2.2.1 Features

The main features of a pension fund are as follows:

- It is an entity.
- It collects funds from employees and employers.
- The proceeds of the collected funds are invested by this entity in securities and other assets.
- Income derived from these investments is utilised to pay benefits to retirees.
- It has a policy. The policy states in which assets and securities where investment is made.
- The benefits are paid to retirees as a lump sum or an annuity.
- It also provides funds to corporations, households and governments for investment or consumption.

5.2.3 Mutual Funds

A mutual fund collects the savings from small investors, invests them in government and other corporate securities and earns income through interest and dividends, besides capital gain. A mutual fund is a form of collective investment. It is a trust that pools the savings of a number of investors who share a common financial goal. It collects the savings from the small investors, invests them in government and other corporate securities and earns income through interest and dividends, besides capital gains. It is a collective savings scheme. It plays an important role in mobilising the savings of small investors and channelling the same for productive ventures in the Indian economy.

A mutual fund is nothing more than a collection of stocks and or bonds. A mutual fund could simply be described as a financial medium used by a group of investors to increase their money with a predetermined investment. SEBI (Mutual Funds) Regulations, 1993 defines a mutual fund as, “a fund established in the form of a trust by a sponsor to raise money by the trustees through the sale of units to the public, under one or more schemes, for investing in securities in accordance with these regulations”.

5.2.3.1 Features

The features of a mutual fund are as follws:

1. Mutual funds are considered the best available investment for common people.

2. It is easy to invest compared with other investments. That can be invested in a diversified, professionally managed portfolio at a relatively low cost. The collected money is used to invest in various stocks, short-term money markets, bonds and other securities.

3. A mutual fund is an association of trusts of public members. The trust managers pool money collected from investors.

4. It is managed by a team of professional fund managers for a small fee. They are called Asset Management Companies.

5. It is a financial intermediary.

6. Mutual funds are financial instruments offered to the public by finance corporations.

7. Mutual fund investments are not risk free.

8. An investor can sell his/her mutual fund instruments and receive payments on the same day.

9. The current value of mutual fund investments is calculated on daily basis and it is reflected in the net present value which is declared by the funds from time to time.

5.2.3.2 Advantages of Mutual Funds

The main advantages of a mutual fund are:

- Easy access to invest
- Portfolio diversification
- Opportunity for small investors
- Professional investment management
- Economies of scale
- Convenience and fair pricing
- Reduction in transaction cost
- Tax benefit
- Transparency in transactions

5.2.3.3 Disadvantages of Mutual Funds

The main disadvantages of a mutual fund are:

- No guarantees of return
- The diversification penalty- Diversification helps to reduce risks of loss from

holding single security, but it limits his potential for a "home run" if single security increases dramatically in value.

- Cost
- High expense ratios and sales charges
- Mutual funds lack liquidity
- Fluctuating returns
- Misleading advertisement can affect investors

5.2.3.4 Types of Mutual Funds

Mutual funds offer many types of schemes with the objective of offering many options to investors to match their investment objectives. These schemes can be broadly divided into;

- By structure, such as open-ended/interval/closed-ended schemes.
- By investment objectives, such as growth, income, balanced and money market schemes.
- Other schemes, such as tax saving schemes, index schemes and sector-specific schemes.

5.2.5 Asset Management Companies

An Asset Management Company is a firm that invests pooled funds from clients, putting the capital to work through different investments including stocks, bonds, real estate etc. Along with the high net worth individual portfolios, AMCs manage hedge funds and pension plans and create pooled structures such as mutual funds, index funds or exchange-traded funds, which they can manage in a single centralised portfolio.

AMCs are colloquially referred to as money managers or money management firms. They are generally distinguished by their Asset Under Management- the number of assets that they manage.

Recap

- Insurance companies- provide insurance to the communities
- Pension funds- a plan, fund or scheme which provides retirement income
- Mutual funds- collective savings scheme
- Asset Management Companies- money management firms

Objective Questions

1. Define Insurance companies.
2. Explain the pension fund.
3. Define mutual funds.
4. Define AMC.

Answers

1. Provide insurance to the communities.
2. A plan, fund or scheme which provides retirement income.
3. Collective savings scheme.
4. Asset Management Companies- money management firms.

Assignments

1. Write a note on Insurance companies
2. Explain Mutual funds.

3. Define Pension fund.

4. Briefly define Asset Management Companies.

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UNIT 3

Money Market in India

Learning Outcomes

After completing this unit, the learner will be able to:

- understand money market
- know instruments traded in the money market
- learn the short-term nature and importance of the money market

Prerequisites

We know that financial markets are both real and virtual markets where financial instruments of varying maturities are traded. Financial markets are highly competitive and facilitate price discovery. The financial system in India consists of the capital market, money market, insurance market, mutual funds and banking system.

Keywords

Financial Market, Money Market, Call Money Market, Treasury Bill Market, Commercial Bill Market, Gilt-edged Market, Collateralised Borrowing and Lending Obligation (CBLO)

Discussion

5.3.1 Financial Market

It is through financial markets and institutions that the financial system of an economy works. Financial markets refer to the institutional arrangements dealing with financial assets and credit instruments of different types such as currency, cheques, bank deposits, bills, bonds etc. The functions of financial markets are:

i. To facilitate the creation and allocation of credit and liquidity

ii. To serve as intermediaries for mobilisation of savings.

iii. To assist the process of balanced economic growth.

iv. To provide financial convenience.

v. To cater to the various credit needs of the business houses.

These organised markets can be further classified into two:

- Money Market
- Capital Market

5.3.2 Money Market

The term market refers to a particular place where goods are bought and sold. It is a place where buyers and sellers meet personally and the transactions of ownership of title take place. In the case of money, there is no specific place set aside where money is borrowed or loaned.

The money market refers to institutional arrangements, which deal with short-term funds. The goods or commodity dealt in the money market is not money in the sense of legal tender money, but the rights or money in the form of credit. Thus the Money market is a market for dealing with financial assets and securities which have a maturity period of up to one year. In other words, it is a market for purely short-term funds. It is a market that deals with near substitutes for money or near money like promissory notes, trade bills and government

Papers drawn for a short period not exceeding one year. It is a mechanism, which makes it possible for borrowers and lenders who meet together to deal in short-term funds.

5.3.2.1 Definitions

According to Madden and Nadler, “a money market is a mechanism through

which short-term funds are loaned and borrowed and through which a large part of financial transactions of a particular country or of the world is cleared".

According to Crowther "Money market is the name given to the various firms and institutions that deal in various grades of near money".

Dealers in the money market consist of the government, commercial and industrial firms, stock exchange brokers, dealers in government and other securities, merchants and manufacturers etc., and commercial banks and central banks.

5.3.2.2 Features of the Indian Money Market

The following are the important features of the Indian money market:

- It is a market for short-term funds or financial assets called near money.
- It deals with financial assets having a maturity period of one year.
- The borrower will get funds for periods varying from a day, a week, a month, or three to six months.
- It is a collection of markets for instruments such as call money, notice money, repos, term money, treasury bills, commercial bills, certificate of deposits, commercial papers, inter-bank participation certificates, inter-corporate deposits, swaps, bills of exchange etc.
- The borrowers of the money market are traders, manufacturers, speculators and government institutions.
- It does not refer to a particular place where borrowers and lenders meet each other.
- The transactions can be carried out through oral or telephonic communications. The relevant documents and written communication can be exchanged subsequently.
- The important components of the money market are the central bank, commercial banks, non-banking financial intermediaries, discount houses and acceptance houses.

5.3.2.3 Features of a well-developed Money Market

In every country, some sort of money market exists. Some of them are highly developed and some others are not well developed. The essential features of a developed money market are given below.

1. **Well-organised banking system**- the existence of a well-developed and organised commercial banking system in a country is an indication of a well-developed money market.
2. **Existence of a central bank**- It is the monetary authority of a country,

which manages the currency and credit policy. It is the leader of the money market and as such, it controls, regulates and supervises the activities of the commercial banks.

3. **Availability of proper credit instruments-** The existence of a well-developed money market depends upon the availability of readily acceptable negotiable securities such as bills of exchange, treasury bills, commercial bills, short-term government bonds, etc in the money market.

4. **Proper coordination of different sectors-** There is proper coordination between different sectors like organised and unorganised sectors in a developed money market. It should not be loosely connected.

5. **Lack of diversity in money rates of interest-** The interest rates do not vary too much among different financial institutions.

6. **Presence of bill market-** the existence of a well-organised bill market is essential for the smooth functioning of a credit system. In an underdeveloped money market, the various sub-markets, particularly the bill market, are absent.

7. **Sufficient resources-** Funds are required to finance the transactions in the sub-markets. These funds are arising from internal and external sources.

8. **Existence of a secondary market-** The secondary market is a market for old or existing securities. The secondary markets are operating in a developed money market successfully.

9. **Ample supply of funds-** In a developed money market, there should be high demand for short-term funds. On the basis of demand, the supply should be made. A well-developed money market is able to attract a large amount of funds from various parts of the world without any difficulty.

10. **Other factors-** Expansion of international trade, industrial development, stability in political conditions etc are other factors, which contribute to the development of a well-defined money market.

5.3.2.4 Functions of Money Market

The major functions of money market are:

1. It facilitates economic development through the provision of short-term funds to industrial and other sectors.
2. It provides a mechanism to achieve equilibrium between the demand and supply of short-term funds.
3. It facilitates the effective implementation of the RBIs monetary policy.
4. It provides ample avenues for short-term funds with fair returns to investors.
5. It instils financial discipline in commercial banks.

6. It provides funds to meet short-term needs

7. It improves capital formation through savings and investment.

8. It helps the employment generation.

9. It provides funds to the government to meet its deficits.

10. It helps to control inflation.

11. It provides a stable source of funds to banks in addition to deposits, allowing alternative financing structures and competition.

5.3.2.5 Defects of the Indian Money Market

A properly organised and well-developed money market is a necessity for the overall economic development of a country. The Indian money market is a loosely organised money market and it is not developed to the fullest extent. It has a number of weaknesses which are mentioned below.

1. **Existence of an Unorganised Money Market-** The unorganised money market mainly consists of indigenous bankers and money lenders. They follow their rules of banking and finance. They occupy a significant portion of the money lending business of our country. A number of steps are taken by the RBI to bring indigenous bankers and money lenders under the organised sector. These attempts have failed because most of the indigenous bankers have not accepted the conditions described by the RBI.

2. **No Co-ordination of Organised and Unorganised Sectors -** Indian money market consists of organised and unorganised money markets. There is little co-operation, co-ordination and contact between the sectors.

3. **Multiplicity in Rates of Interest-** A number of interest rates are prevalent in our country. The rate of interest charged by various institutions varies from institution to institution. It may be different from season to season.

4. **Seasonal Stringency of Funds-** November to June is the busy season because funds are required at that time for harvesting and marketing. The crops are to be moved from villages to the cities. More funds are required at that period. It causes stringency of funds and enhances the rate of interest. But in the slack season, the demand for funds is less and the interest rate also declines.

5. **Absence of Bill Market-** A well-organised bill market is essential for the smooth functioning of the Credit system. A well-developed bill market is absent in India.

6. **Inadequate Banking Facilities**- Indian money market is inadequate to meet the financial needs of our country. The problem has been tackled to some extent through a planned branch expansion programme. Even then the rural areas still lack banking facilities.

7. **Absence of a Well-Organised Banking System-** A well-organised and properly integrated commercial banking system is necessary to meet the short-term credit needs of the economy. Such an organised banking system is absent in our country.

8. **Absence of Specialised Financial Institutions-** specialised financial institutions are lacking to carry out specialised jobs in certain fields.

9. **Absence of Sufficient Submarket-** the Indian money market does not contain the very essential submarkets like the call money market, the acceptance market and the commercial bill market. Commercial banks do not grant call loans to traders or brokers.

5.3.2.6 Structure of the Indian Money Market

The main components of the Indian money market are the unorganised banking sector and organised banking sector with several submarkets which deal with the borrowing and lending of short time credits.

1) Unorganised Banking Sector

It consists of indigenous bankers and money lenders in the country who pursue banking business on traditional lines. They cater to the credit needs of a large number of people in the countryside.

a) Indigenous Bankers

Indigenous bankers mainly operate in small towns, semi-urban areas and rural areas. The Indian Central banking enquiry committee defined indigenous bankers as individuals or private firms receiving deposits and dealing in hundies or lending money. They accept deposits on current accounts and fixed deposits. They lend money to small farmers and traders. They are playing an important role in the Indian money market by helping traders and farmers. The main limitation of indigenous bankers is that they follow conservative practices and are not governed by the RBI.

b) Money Lenders

Money lenders constitute one of the components of the unorganised money market of our country. Money lenders are those persons who do not accept deposits from the public but merely lend their own funds. They lend money mainly for consumption and other domestic purposes. They lend money to the personal security of the borrower. If the amount of loan is a huge amount they insist on a promissory note. They charge an exorbitant rate of interest for the advances granted by them.

2) Organised Banking Sector

The organised banking sector consists of The Reserve Bank of India, State Bank of India and other nationalised banks, private sector banks, cooperative banks, regional rural banks, special institutions like LIC, UTI, IDBI, SFCs, NABARD, Exim bank etc. The RBI is the central bank and monetary authority of our country. So RBI is the leader of the Indian money market.

5.3.3 Call Money Market

The Call money market is the market for very short-term funds. It is sometimes referred to as "loans of money at call and short notice". These are very short-term loans which are granted for overnight use or for 24 hours or for a maximum of 7 days. They can be recalled on demand or at the shortest possible notice. The rate at which funds are borrowed and lent in this market is called the call money rate. Collateral securities are not insisted on for these loans.

5.3.3.1 Call Money markets in India

The call money markets are mainly located in developed industrial centres like Mumbai, Kolkata, Ahmedabad, Delhi, Chennai etc. Banks mainly utilise it. The banks that are in need of temporary funds will take this loan from the banks that have excess funds. So this is called the interbank money market.

5.3.3.2 Merits of Call Money Market

- **Profitability-** Banks can invest their surplus funds in the call money market when call rates are high. It offers high profitability to banks.
- **High liquidity**- Money invested in the call money market can be recalled at any time.
- **Helps to maintain statutory reserve requirements**- Banks can borrow a large amount of funds from the call money market to meet the statutory reserve requirements.
- **Safe and cheap-call loans are available-** At the same time it is cheap because the brokers are not permitted to operate in the call money market and so the banks are not incurring any brokerage.
- **Helps the central bank**- Any changes occurring in demand and supply of money are very well reflected in call markets. It will help the central bank to determine an appropriate monetary policy.

5.3.3.3 Demerits

- **Confined to big cities-** The call market is situated in big cities like Mumbai, Kolkata, Chennai, Bangalore, Ahmedabad and Delhi. It is also associated with stock exchanges. So it is not developed in other cities and its development is uneven.
- **Lack of integration**- The call market is not properly integrated.
- **Call Money rates are volatile in nature-** Call rates are different in different centres and in different seasons or on different dates.
- **Small size-** The size of the call money market is smaller compared to the

UK and USA. It is due to the underdevelopment of the Bill market in India.

- Commercial banks are not inclined to offer loans to brokers and dealers in bills and securities. It is another limitation to the growth of the call money market.

5.3.4 Bill Markets in India

The Bill market or the discount market is the most important part of the money market where short-term bills normally up to 90 days are bought and sold. The Bill market is further subdivided into commercial bill market and Treasury bill market.

5.3.4.1Treasury Bill Market

The 91 day treasury bills are the most common way the Government of India raises fund for the short period. Some years ago, the government introduced the 182 day treasury bills which was later converted into 364 days treasury bills. In 1997, the government introduced the 14-day intermediate Treasury bill. The treasury bills other than providing short-term cushion to the government also function as short-term investment avenues for the banks and financial institutions, besides functioning as requirements of the CRR and SLR of the banking institutions.

5.3.4.2 Commercial bill market

The market for commercial bills has not become popular in India unlike in London and other international money markets where commercial bills are extensively bought and sold. The commercial bill market is a vital source of the short-term funds needed by trade and industry. It helps to activate the money market. Commercial banks in India perform an important role in the Bill market.

5.3.4.3 Merits

- **High liquidity-** The bill offers high liquidity. The bill can be converted into cash immediately.
- **Certainty in payment-** Generally bills are accepted by the business people who are honouring the bills on the date accurately.
- **Self-liquidating in character-** It has a fixed due date.
- **Ideal for investment-** Commercial banks can invest their surplus funds in commercial bills.
- **Quick yield-** Financial institutions can earn high yields than loans and advances.
- **Control-** The central bank can control the money market by manipulating the bank rate or discount rate.

5.3.4.4 Limitations

Even now India has no well-developed bill market. It is due to the following reasons.

- Lack of bill culture
- No rediscounting between banks
- Absence of secondary market
- No proper development of foreign trade
- Domination of indigenous bankers
- Cumbersome procedures
- Absence of specialised institutions

5.3.5 Gilt-Edged Market

The government securities comprise dated securities issued by the Government of India and the state governments. The date of maturity is specified in the securities. Therefore it is known as dated government securities. At present, there are dated securities with tenure of up to 20 years in the market. Securities issued by the central government, state Government, semi-government authorities like city corporations, port trust etc., improvement trusts, state electricity boards, all India and state level financial institutions and public enterprises are dealt in this market.

The government can borrow funds through the issue of long-term dated security, the lowest risk category instrument in the economy. These securities are issued through an auction conducted by RBI where the central bank decides the coupon or discount rate based on the response received. The investors in government securities are mainly banks, foreign investors, insurance companies, provident funds and trusts. These investors are required to hold a certain part of their investment or liabilities in government paper. Foreign institutional investors can also invest in the security of up to 100% of funds in the case of dedicated debt funds and 49% in the case of equity funds.

5.3.6 Collateralised Borrowing and Lending Obligation

Financial Institutions often need liquidity or ready cash to meet their transactions. Quick money or short-term money can be obtained by financial institutions from the Collateralised Borrowing and Lending Obligations Market.

CBLO market is a money market segment operated by the Clearing Corporation of India Ltd (CCIL). In the CBLO market, financial entities can avail short-term loans by providing prescribed securities as collateral. In terms of functioning and objectives, the CBLO market is almost similar to the call money market. The uniqueness of CBLO is that lenders and borrowers use collateral for their activities.

For example, borrowers of funds have to provide collateral in the form of government securities and lenders will get it while giving loans. There is no such need for collateral under the call money market.

Institutions participating in the CBLO are entities who have either no access or restricted access to the interbank call money market. Institutions active in the call money market can participate in the CBLO market. Nationalised banks, private banks, foreign banks, insurance companies, mutual funds, primary dealers, bank cum primary dealers, NBFC, corporate, provident/pension funds etc. are eligible for CBLO membership.

Collateralised Borrowing and Lending Obligation (CBLO) is the instrument in the CBLO market. It is a discounted instrument available in the electronic book entry form for the maturity period ranging from one day to one year. In the CBLO market members can borrow or lend funds against the collateral of eligible securities. Eligible securities are Central Government securities including Treasury bills and such other securities as specified by the CCIL. Borrowers in CBLO have to deposit the required amount of borrowing and lending orders submitted by the members. Borrowers have to pay interest to the lenders in accordance with the bid.

Recap

- Financial market - institutional arrangement dealing with financial assets and credit instruments
- Money market - institutional arrangements, which deal with short-term funds
- Features of the Indian money market and a well-developed money market.
- Indian money market: unorganised banking sector and organised banking sector
- Unorganised banking sector: indigenous bankers and money lenders
- The Call Money market is the market for very short-term funds. 'Money at call'
- Bill market or the discount market: short-term bills normally up to 90 days are bought and sold.
- Treasury bills - the Government of India raises funds for the short period.
- Commercial bill market - a source of the short-term funds needed by trade and industry.

- Gilt edged market- market deals with government securities.
- Collateralised Borrowing and Lending Obligations Market - for short term loans. Lenders and borrowers use collateral for their activities.

Objective Questions

1. Define the Financial market.
2. Write down any 2 functions of the financial market.
3. Name the major classification of the financial market.
4. Define the money market.
5. Explain any 3 essential features of a developed money market.
6. Define indigenous bankers.
7. What do you mean by organised banking sector?
8. Define the call money market.
9. What is called the Treasury bill market?
10. Define Gilt-edged market.
11. Explain CBLO.

Answers

1. Institutional arrangement dealing with financial assets and credit instruments.
2. (i) To facilitate the creation and allocation of credit and liquidity

   (ii) To serve as intermediaries for mobilisation of savings.
3. Money Market and Capital Market
4. Institutional arrangements, which deal with short-term funds.

5. Well-organised banking system, Existence of a central bank, Availability of proper credit instruments.
6. Pursue banking business on traditional lines.
7. The organised banking sector consists of The Reserve Bank of India, State Bank of India and other nationalised banks.
8. The Call Money market is the market for very short-term funds.
9. The Government of India raises funds for the short period.
10. Market deals with government securities.
11. Short term loans. Lenders and borrowers use collateral for their activities.

Assignments

1. Briefly explain the functions and features of the Indian money market.
2. Critically examine the defects of the Indian money market.
3. Discuss the merits and demerits of the call money market in India.
4. Explain the merits and limitations of the bill market.
5. India has no well- developed bill market. Elaborate the reasons.

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Financial Market 2

UNIT 1

Capital Market

Learning Outcomes

After completing this unit, the learner will be able to:

- know about capital market and its functions
- understand the divisions of capital market
- explain different methods of public issues

Prerequisites

Previously, we dealt with the short term market, money market. In this unit, we will look at long term markets, referred to as capital markets where usually bonds, shares etc. are traded. You might be familiar with the famous sentence in advertisements, 'Mutual Funds are subject to market risks'. This mutual fund is a concept discussed under capital markets. Capital markets are where savings and investments are channeled between suppliers and those in need. Suppliers are people or institutions with capital to lend or invest and typically include banks and investors. Those who seek capital in the market are the government and individuals.

Introduction to the capital market offers a comprehensive overview of the industry and the economy. Let us discuss about the capital market.

Keywords

Capital Market, Primary Market, Secondary market, IPO, FPO

Discussion

6.1.1 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 institutional arrangements for borrowing and lending term funds (mid term and long term funds). It is concerned with the raising of money capital for the purpose of investment. The demand for a long term money capital comes mainly from private sector manufacturing industries and agriculture and from the Government, largely for the purpose of economic development. The supply of funds for the capital market comes largely from individual savers, corporate savings, banks, insurance companies, specialised financing agencies and the government.

6.1.1.1 Functions of Capital market

Capital market is the market for raising funds for capital formation and investment. So, the main function performed by the capital market is the investment functions.

1. **Investment Function**- It consists of capital formation and promotion of the investment. The savings and investment, which are promoted by the capital market, is the base of the economic development of a country. Savings of the people are to be mobilised for the purpose of channelising it into productive functions.

2. **Help Economic Growth**- Capital market helps in the proper allocation of resources from the people who have surplus capital to the people who are in need of capital.

3. **Promote Saving Habits**- After the development of capital markets, the taxation system, and the banking institutions provide facilities and provisions to the investors to save more. In the absence of the capital market, they might have invested in unproductive assets like land or gold or might have indulged in unnecessary spending.

4. **Stable and Systematic Security Prices-** Apart from the mobilisation of funds, the capital market helps to stabilise the prices of stocks. Reduction in the speculative activities and providing capital to borrowers at a lower interest rate help in the stabilisation of the security prices.

5. Facilitate trading of securities.

6. Minimisation of transaction and information cost.

7. Encourage a wide range of ownership of productive assets.

8. Quick valuation of financial instruments like shares and debentures.

- Facilitates transaction settlement, as per the definite time schedules.
- Offering insurance against market price risk, through derivative trading.
- Improvement in the effectiveness of capital allocation, with the help of competitive price mechanisms.

Like all markets, the capital market is also composed of those who demand funds and those who supply funds. An ideal capital market attempts to provide adequate capital at the reasonable rate of return for any business or industrial proposition which offers a prospective yield high enough to make borrowing worthwhile.

The industrial securities market is further divided into new issue markets and old capital markets or the stock exchange. The new issue market, often referred to as Primary market, refers to the raising of new capital in the form of shares and debentures whereas the old issue market commonly known as stock exchange or stock market deals with the securities already issued by companies. It is also known as a secondary market.

6.1.2 Structure of Primary Market

The primary market is a market in which new securities or the new companies or the existing companies offer financial claims to the investors for the first time. Fresh capital can be raised from this market by companies, government and semi government bodies, public sector undertakings etc., either for cash or for consideration other than cash. Primary market includes all institutions which are dealing in fresh claims. These claims are created by institutions in the form of equity shares, preference shares, debentures, right issue, deposits etc. Development corporations like IFCI, ICICI and investment corporations like LIC, GIC, UTI and other financial institutions contribute to the majority of underwriting activity and direct investment. Banks and brokers also participate in underwriting activity.

6.1.2.1 Functions of Primary Market

The main function of the new issue market is to assist in the transfer of funds from investors to the clients. The clients are companies, government and semi government bodies, public sector undertakings etc. The investors in the primary markets are mainly government, individuals, and public companies. The main functions of the primary market can be classified under the following heads:

1. **Origination-** The introduction of the basic idea of issuing securities and the related spade work before the actual issues of securities is known as origination. For this purpose, an analysis of economic conditions, investment climate and corporate legal environment should be carried out before floating the new issue in the market. A preliminary investigation should be conducted by the sponsors of the new issue market in respect of technical, economic and financial viability of the project. On the basis of this study, advice is given on the type of issue, magnitude of issue, time of floating issue, pricing of the issue, method of issue and technique of selling of the securities. The

act of origination requires exceptional imagination and entrepreneurial zeal. Generally, the function of the origination is done by the merchant bankers, which may include commercial banks, All India Financial Institutions or private firms.

2. **Propagation**- After origination the new shares should be propagated. The prospects of the new issue should be highlighted to the investors. They should be informed about the benefits of the investment opportunity. Information about the new issue should be initiated to the investors through appropriate media. Investor's club, press releases, advertisements, and electronic media like the internet are extensively used.

3. **Underwriting-** It is a contract of guarantee by which the underwriter agrees to take over the shares, which are not taken by the public. For this service, he gets a commission called underwriting commission. It is the act of ensuring the sales of shares or debentures of the company, even before offering to the public. The person or parties who are engaged in such activities are called underwriters. The underwriters ensure minimum subscription and propagate about the issue in the new issue market. If a part of the shares is unsold, the underwriter will buy that share.

4. **Distribution-** It is the function of the final sale of securities to prospective investors. Generally, brokers or agents who are engaged in the business of distribution do the distribution business.

6.1.3 Structure of Secondary Market

The secondary market is also referred to as the stock market. The securities which are originally issued in the new market or primary market are then traded in the secondary market. So, the secondary market deals with the sale and purchase of already issued equity and debt securities of the corporates and others. The securities dealt in the secondary market include securities of government, semi-government or other public bodies and the public issue done by companies. The companies list their securities in the stock exchanges for trading. The sale and purchase of the listed securities is carried out in these specific stock exchanges. The security traded in the stock exchange includes equity shares, preference shares and various types of debentures of listed companies, long dated securities of the government, bonds and debentures of quasi government organisations like municipal corporation and port trust etc. and the bonds of public sector enterprises. The stock exchange provides an organised market place for investors to buy and sell securities freely.

6.1.3.1 Functions of Secondary Market

The main function of the secondary market is to provide liquidity to the listed securities. The secondary market also acts as a significant indicator of the investment climate in the economy. Basically, the secondary market performs three functions such as capital formation, security price formation and creation of a marketplace.

1. Capital formation

Large number of persons are engaged in buying and selling of securities through the secondary market. The savings of the people are channelised through the stock market for the development of the nation. The investors are always looking for profitable investments. So, the secondary market becomes a channel for capital formation for the reputed companies.

2. Security price formation

The prices of securities are formed through the dealings done in the secondary market. It is generally decided according to the opinion of investors. The investors evaluate the performance and prospectus of the company and determine the price of securities.

3. Creation of market place

Secondary market has a physical existence through stock exchanges. The buyers and sellers assemble in the stock exchanges for buying and selling securities. The market place is formed and always regulated by rules and regulations.

6.1.4 Methods of Public Issue

Public issues can be classified into Initial Public Offerings and Further Public Offerings. In a public offering, the issuer makes an offer for new investors to enter its shareholding family.

Initial Public Offering (IPO)

The term IPO stands for Initial Public Offer and it is in practice in the primary market of shares and stocks. It is the first issue of shares of a company to the public. IPO is done when an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public. This paves way for listing and trading of the issuer's securities. IPOs are often issued by smaller, younger companies seeking capital to expand, but also by large privately owned companies looking to become publicly traded. IPOs can be a risky investment.

Follow on Public Offer

A follow-on public offer is the issuance of shares to investors by a company listed on a stock exchange. A follow-on offering is an issuance of additional shares made by a company after an Initial Public Offering.

6.1.5 Book Building

Book building may be defined as a process used by companies raising capital through public offerings both Initial Public Offerings and Follow-on Public Offerings to aid price and demand discovery. It is considered to be one of the most efficient mechanisms of pricing securities in the primary market. The process of price discovery involves generating and recording investor demand for shares before arriving at an issue price.

It is a mechanism where, during the period for which the book for the offer is open, the bids are collected from investors at various prices which are within the price band specified by the issuer. The process is directed towards both institutional investors as well as the retail investors. The issue price is determined after by the bid closure based on the demand generated in the process. Book Building is actually a price discovery method.

6.1.6 Domestic Institutional Investors

Domestic institutional investors are those institutional investors who undertake investment in securities and other financial assets of the country they are based in. Simply stated, Domestic institutional investors use pooled funds to trade in securities and assets of their country. Institutional investment is defined to be the investment done by institutions or organisations such as banks, insurance companies, mutual fund houses, etc. in the financial or real assets of a country. These investment decisions are influenced by various domestic economic as well as political trends. In addition to the foreign institutional investors, the domestic institutional investors also affect the net investment flows into the economy.

Recap

- Capital market- the market for long-term funds
- The industrial securities market- the market for shares and debentures of old and new companies
- The primary market- the market in which new securities offer for the first time
- Functions of the primary market - Origination, Propagation, Underwriting, Distribution
- Underwriting- a contract in which the underwriter agrees to take over the shares, which are not taken by the public
- Underwriters- The person or parties who are engaged in underwriting
- Secondary market- the stock market
- IPO- Initial Public Offer
- A follow-on public offer is the issuance of shares to investors by a company listed on a stock exchange
- Book building- a process used by companies raising capital through public offerings
- Domestic institutional investors- institutional investors who undertake investment in securities and other financial assets of the country they are based in

Objective Questions

1. Define Capital Market.
2. Note down any two functions of the Capital Market.
3. Write the major divisions of the Indian Capital Market.
4. Define New Issue Market.
5. What do you mean by Stock exchange?

6. Explain primary market.
7. What is called underwriting?
8. Who are underwriters?
9. Explain Secondary Market?
10. Define IPO.
11. Explain FPO.
12. What is called Book building?
13. Who are Domestic Institutional Investors?

Answers

1. Capital market- the market for long-term funds.
2. Investment function and promote saving habits.
3. Primary market and Secondary market.
4. The primary market- the market in which new securities offer for the first time.
5. Stock exchange- secondary market.
6. The market in which new securities are offered for the first time.
7. A contract in which the underwriter agrees to take over the shares, which are not taken by the public.
8. The person or parties who are engaged in underwriting.
9. The stock market.
10. IPO- Initial Public Offer
11. A follow-on public offer is the issuance of shares to investors by a company listed on a stock exchange
12. Book building- a process used by companies raising capital through public offerings.

13. Domestic institutional investors- institutional investors who undertake investment in securities and other financial assets of the country they are based in.

Assignments

1. Explain Capital Market and its functions.
2. Define Industrial Securities Market and its division.
3. Explain the major functions of secondary market.
4. Differentiate the primary and secondary market.
5. Explain different methods of public issues.

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UNIT 2

Investment Groups

Learning Outcomes

After learning this unit, the learner will be able to:

- understand the major investment groups
- know the domestic institutional investors
- get an idea about the Foreign Portfolio Investors

Prerequisites

Let us imagine a small business owner, Raj, who wants to expand his shop. To do this, he needs more money. Instead of using only his own savings, he decides to ask different types of investors for help. These investors play different roles in providing the capital they need, just like investors play different roles in a country's financial markets. Retail investors are people like Raj who invest small amounts of money, often from their own savings. These are everyday individuals, such as friends, family, or neighbours, who pool their resources to help someone like Raj fund his business expansion. They contribute small amounts, but together, their money grows into something much larger. In Raj's story, we can think of banks, insurance companies, and mutual funds as larger institutions. They do not just rely on individuals like Raj does. Instead, they collect large amounts of money from many people and use that money to invest in their own country's financial markets. These institutions help keep the economy stable and ensure long-term growth. Now, imagine someone like Maya - a wealthy businesswoman from another country - hearing about Raj's shop. She decides to invest in his shop from her city, bringing in capital from abroad. This is how Foreign Portfolio Investors work - they invest from other countries into a different country's financial markets. Just like Raj brought together his friends, family, banks, and even outsiders to grow his business, a country's economy relies on these different types of investors - Retail Investors, Domestic Institutional Investors, and Foreign Portfolio Investors.

Keywords

Investment Groups, Retail Investors, Domestic Institutional Investors, Foreign Portfolio Investors, Foreign Direct Investment

Discussion

6.2.1 Major Investment Groups

Financial markets are driven by various groups, each playing distinct roles and pursuing different objectives. Retail investors, domestic institutional investors, and foreign portfolio investors (FPIs) are among the key groups contributing to capital flows and shaping market dynamics. Retail investors, typically individual participants, invest for personal returns and diversification. Domestic Institutional Investors, including pension funds, insurance companies, and mutual funds, play a significant role in providing long-term capital essential for economic growth. Foreign Portfolio Investors (FPIs) bring international capital, seeking diversification and higher returns. Understanding these major investment groups is key for analysing market trends, liquidity, and the impact on financial stability and economic development.

6.2.1.1 Retail Investors

A retail investor is an investor who uses his/her own money to buy and sell securities or funds. They are also known as individual investors or retail traders. Retail investors allocate their money across various assets, including stocks, bonds, securities, mutual funds, and exchange-traded funds (ETFs). Retail investors are a key part of the stock market. They execute their trading activities through traditional or online brokerage firms or investment accounts. They typically invest smaller amounts compared to institutional investors. Due to their limited purchasing power, retail investors may pay higher fees or commissions. However, with the rise of online trading platforms, many brokers now offer fee-free trading, making investing more accessible and affordable.

6.2.1.2 Domestic Institutional Investors (DII)

Domestic Institutional Investors are organisations that invest in their own country's financial assets, such as stocks and bonds. Banks, insurance companies, and mutual funds are examples of domestic institutional investors. They make investments by collecting money from different people. Like foreign investors, DIIs play an important role in determining how much money flows into the country's economy. DIIs play a key role in the financial stability and economic growth of a country. DIIs are essential for maintaining market equilibrium, especially during periods when foreign investors withdraw their investments. When this happens, DIIs step in to ensure that financial markets remain stable and avoid extreme fluctuations. Their investment decisions are

guided by thorough economic research and analysis, helping to shape market trends and support sectors that promise growth. By channeling funds into areas like start-ups, technology, and e-commerce, DIIs foster innovation and contribute to the country's economic development.

The Indian government has worked hard to strengthen the country's economy. India is also becoming a hub for start-ups in areas like online shopping, technology, and transport, which create new markets and drive innovation. Domestic investments from both the public and private sectors are a significant reason for India's economic growth.

Here are the key contributors to these investments:

- Government and public sector projects
- Private companies
- Banks, financial institutions, and domestic institutional investors
- Individual retail investors

These combined efforts of these contributors are helping India grow and build a strong economy

6.2.1.3 Foreign Portfolio Investors

Foreign Portfolio Investment (FPI) refers to investments made by foreign investors in a country's financial markets, such as stocks, bonds, and other securities, without direct involvement in the management or control of the businesses that issue these assets. FPI focuses on acquiring financial instruments for the purpose of earning returns through capital appreciation. Foreigners purchasing shares of Indian companies, investments in government or corporate bonds issued by Indian entities, and foreign mutual funds investing in Indian financial markets are examples of Foreign Portfolio Investment (FPI). FPI differs from Foreign Direct Investment (FDI). FDI refers to investments made by individuals, companies, or institutions in one country into business enterprises located in another country. These investments typically involve establishing a business presence, such as setting up subsidiaries, acquiring assets, or obtaining significant ownership stakes in existing companies. FDI is characterised by active control and ownership of the business or entity where the investment is made. Some of the key characteristics of FPI are:

- **Passive Holdings:** FPI investors typically do not seek direct control or management of the companies whose securities they purchase. Their involvement is limited to buying and selling financial assets like shares or bonds.
- **Diversification:** FPI allows investors to diversify their portfolios across multiple countries, aiming to reduce risks associated with domestic markets.
- **Liquidity:** Investments are often easily transferable, making FPI highly liquid, unlike FDI which often involves longer-term commitments.

- **No Active Management:** FPI investors rely on the performance of financial markets rather than direct involvement in the business operations of the companies.

Significance of Foreign Portfolio Investment (FPI)

- **Capital Inflows**

FPI brings capital into a country's financial markets improving liquidity and supporting the development of the capital markets. This entry of funds helps various sectors like infrastructure, industry, and services, fostering overall economic growth.

- **Market Efficiency**

The presence of foreign investors typically improves market efficiency by encouraging better corporate governance, accountability, and transparency. Companies may strive to meet international standards, thereby improving investor confidence and market integrity.

- **Economic Growth**

FPI contributes to economic growth by providing essential funds for investment in different sectors such as manufacturing, services, and technology. It helps stimulate domestic businesses, create jobs, and increase productivity.

- **Foreign Exchange Reserves**

FPI strengthens a country's foreign exchange reserves, allowing the country to better manage external economic shocks and maintain stability in foreign exchange rates.

- **Risk Diversification**

For investors, FPI offers an opportunity to diversify their portfolios by investing in multiple markets, spreading risk, and reducing dependence on a single country or asset class.

- **Access to Global Markets**

FPI allows investors from developed economies to access the growth potential in emerging markets, potentially leading to higher returns due to expanding economies and increasing consumer demand.

Issues with Foreign Portfolio Investment (FPI)

- **Volatility**

FPI is highly liquid, meaning investments can flow in and out rapidly. This volatility can create instability in financial markets, particularly when large amounts of foreign capital withdraw suddenly.

- **Speculative Nature**

FPI is often driven by short-term speculative motives, which can lead to price bubbles followed by sharp market crashes, causing disruptions in the financial markets.

- **Exchange Rate Fluctuations**

Large inflows and outflows of FPI can lead to significant exchange rate fluctuations, impacting the competitiveness of exports and potentially causing adverse effects on economic stability.

- **Regulatory Challenges**

FPI requires legal and regulatory frameworks to prevent market manipulation and ensure investor protection. Without proper regulation, it can lead to market inefficiencies, regulatory arbitrage, and a higher risk of financial crises.

Recap

- In financial markets, the major players are retail investors, domestic institutional investors, and foreign portfolio investors
- Retail investors are non-professional individuals who invest their own money in securities or funds
- Retail investors diversify their investments across stocks, bonds, securities, and mutual funds
- Retail investors are a key part of the stock market. They execute trades through traditional or online brokerage firms or investment accounts
- Retail investors typically invest smaller amounts compared to institutional investors
- Domestic institutional investors (DIIs) are organisations that invest in a country's financial assets like stocks and bonds
- Examples of DIIs include banks, insurance companies, and mutual funds
- DIIs make investment decisions based on thorough economic research and analysis
- DIIs help maintain market equilibrium, particularly when foreign investors withdraw
- FPI refers to investments made by foreign investors in a country's financial markets (stocks, bonds, securities) without controlling the businesses involve
- Unlike FDI, FPI does not involve active management or control of businesses
- FPI does not have direct control or management of companies
- FPI allows investors to spread their investments across different countries, reducing risks
- FPI investments are easily transferable, making them highly liquid
- In the case of FPI, investors focus on market performance rather than business operations

Objective Questions

1. Who are retail investors?
2. What role do DII play in a country's financial markets?
3. Define FPI.
4. How do domestic institutional investors contribute to a country's economic growth?

Answers

1. Non-professional individual investors investing with their own funds
2. Provide long-term capital essential for economic growth
3. Investments in financial markets without direct control over businesses
4. By funding start-ups, technology, and e-commerce sectors

Assignments

1. Explain about FPIs.
2. Explain the role of DIIs.
3. Elucidate on major investment groups.

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Suggested Readings

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UNIT 3

Structure and Functions of SEBI

Learning Outcomes

After completing this unit, the learner will be able to:

- understand the historical background and reasons for the establishment of SEBI
- identify the key milestones in the evolution of SEBI
- know the structure, primary functions, and powers of SEBI

Prerequisites

Suppose, you want to invest your money in the stock market or mutual funds to grow your savings. But how can you be sure that your money is safe, and the companies or brokers you deal with are trustworthy? That is where SEBI, or the Securities and Exchange Board of India, comes into the picture. SEBI is like a referee for the financial markets in India. Just as a referee ensures fair play in a game, SEBI ensures that everyone involved in the stock market like investors, companies, and brokers follows the rules.

SEBI, serves as the primary regulator of the securities market in India. Its primary role is to regulate, monitor, and oversee the activities of the stock market to ensure transparency, fairness, and efficiency. SEBI plays a crucial role in maintaining the trust of investors and growth in the financial markets.

But is SEBI limited to regulating the stock market? What lies beyond its core responsibilities? Why was SEBI established in the first place, and how has it evolved over the years? Understanding these aspects is vital for anyone looking to grasp the bigger picture of India's financial ecosystem.

Keywords

Securities and Exchange Board of India, Controller of Capital Issues, Primary Market, Secondary Market

Discussion

6.3.1 Securities and Exchange Board of India (SEBI)

Financial sector in India has experienced a better environment to grow with the presence of higher competition. The financial system in India is regulated by independent regulators in the field of banking, insurance and mortgage and capital market. The Ministry of Finance, The Government of India, controls the financial sector in India. Reserve Bank of India is an apex institution in controlling the banking system in the country. Securities and Exchange Board of India is one of the regulatory authorities for India's capital market. SEBI, established in 1988 and granted statutory powers in 1992, emerged in response to the growing need for a regulatory authority to oversee India's expanding securities market. During the late 1980s, the financial market faced challenges such as fraudulent practices, insider trading, and lack of transparency, which eroded investor confidence. To address these issues, SEBI was formed with the mission to promote and protect the interests of investors while ensuring the development of a fair and efficient market. Over the years, SEBI has played a key role in maintaining stability, enhancing market transparency, and facilitating the smooth functioning of capital markets in India.

Beyond regulating stock exchanges, SEBI's responsibilities extend to supervising market intermediaries such as brokers, asset management companies, and depositories. It formulates policies to ensure investor protection, enforces compliance with regulations, and curbs malpractices like insider trading. SEBI also educates investors, monitors mutual funds, and facilitates capital raising by companies while maintaining market integrity.

6.3.2 Historical Background of SEBI

In India, the regulation of stock exchanges and capital markets has evolved significantly over time. Initially, the stock exchanges were directly regulated by the Government of India under the Securities Contract (Regulation) Act, 1956. This framework remained in place until the late 1980s. During this period, the government had a central role in ensuring that stock exchanges operated in a fair and transparent manner.

When it came to the primary capital market, where companies raise funds by issuing shares and other securities for the first time, it was under the control of the Controller

of Capital Issues (CCI). The CCI was established under the Capital Issues Control Act, 1947, and its role was to oversee and regulate the issuance of securities by companies. This included determining the pricing of capital issues, which means setting the price at which new shares or securities could be offered to investors. For example, if a company wanted to issue new equity shares, the premium or additional cost above the nominal value of shares had to be approved by the CCI. This regulation ensured that companies could not set arbitrary or excessively high prices for their securities, thus protecting investors and maintaining stability in the financial markets. However, as India's economy started to liberalise in the early 1990s, there was a shift towards reducing government control and promoting a market-driven approach. A major milestone in this direction was the abolition of the Capital Issues Control Act on May 29, 1992. This marked the end of the Controller of Capital Issues' authority over the pricing and issuance of capital. Companies were no longer required to seek prior approval from the CCI for raising capital or deciding the pricing of their securities. This deregulation allowed companies greater freedom in accessing capital markets, aligning with India's broader economic reforms aimed at liberalisation and globalisation. This transition not only modernised the regulatory framework but also helped develop a more competitive and dynamic capital market in India. By removing government-imposed restrictions on capital issues, companies could now respond more effectively to market demands, and investors gained greater opportunities to participate in the growth of businesses.

SEBI was established on April 12, 1988, through an administrative order issued by the Government of India. Initially, SEBI functioned as a non-statutory body, meaning it did not have legal powers and was set up mainly to promote the growth of the securities market, ensure adequate investor protection, and act as an independent regulator for entities like stock exchanges, the primary market, and mutual funds. It played an important role in maintaining fair practices in the financial markets. SEBI operates under the control of the Ministry of Finance and has its headquarters in Mumbai, along with three regional offices located in New Delhi, Kolkata, and Chennai.

SEBI became a statutory body and gained significant legal powers in 1992 when the CCI was abolished. With the removal of the CCI, SEBI was entrusted with regulating the issuance and pricing of securities, thereby becoming a key authority in managing India's financial markets. This transformation strengthened SEBI's ability to ensure the proper functioning of the securities market and to safeguard the interests of investors.

In September 1994, through a Gazette notification, the Government of India delegated its powers under the Securities Contracts (Regulation) Act, 1956 to SEBI. This step further empowered SEBI to regulate stock exchanges and related market activities. In January 1995, SEBI's regulatory authority was further expanded through the Securities Laws (Amendment) Ordinance, which was later replaced by an act passed by Parliament. These changes made SEBI one of the most important institutions in India's financial regulatory framework, giving it the authority to oversee and manage key aspects of the securities market.

Today, SEBI plays a major role in strengthening India's financial markets. By regulating activities like stock market trading, mutual fund operations, and public share offerings, SEBI has become a cornerstone of India's financial system.

6.3.3 Structure of SEBI

SEBI has a well-defined structure as outlined in the SEBI Act. This structure includes a statutory body consisting of six members who are responsible for overseeing and managing the affairs of SEBI. The members are carefully selected to ensure a balance of expertise and representation. The composition of SEBI includes:

- A Chairman, who leads the board.
- Two members from the Central Government, representing the Ministries of Finance and Law, to ensure alignment with government policies.
- One member from RBI, to provide expertise in monetary and banking-related matters.
- Two additional members appointed by the Central Government, chosen for their professional experience or specialised knowledge in the securities market.
- The overall management, direction, and superintendence of SEBI are vested in this board of members. They hold the authority to make decisions, exercise powers, and take necessary actions to ensure the smooth functioning of SEBI and the regulation of the financial markets.

To handle its responsibilities efficiently, SEBI's activities are divided into four main operational departments, each focusing on a specific area.

- Primary Market Department, which oversees the issuance of new securities, including shares and bonds, by companies in the primary market.
- Secondary Market Department, which regulates the trading of securities in stock exchanges after they have been issued.
- Issue Management Department, which supervises the processes related to the public offering of securities, such as Initial Public Offerings (IPOs).
- Intermediaries Department, which manages and monitors the activities of market intermediaries like brokers, mutual fund managers, and investment advisors.

This structured approach allows SEBI to fulfil its mandate of regulating and developing India's securities market.

6.3.4 Functions of SEBI

The Securities and Exchange Board of India (SEBI) has been instrumental in transforming the investment market to benefit common investors. It performs a wide range of functions aimed at regulating, promoting, and developing the securities market. The key functions of SEBI are as follows.

1. **Investor Protection and Market Regulation**: SEBI's primary responsibility is to safeguard investors' interests by ensuring that the securities market operates fairly, transparently, and efficiently. It works to create a secure investment environment by enforcing regulations that prevent fraudulent activities, insider trading, and market manipulation. SEBI promotes the development of the market by introducing reforms that enhance transparency, accountability, and investor confidence. Additionally, it ensures that market intermediaries, such as brokers and fund managers, adhere to established standards and practices. SEBI's role in educating investors helps them make informed decisions, reducing the risk of exploitation.

2. **Regulating Stock Exchanges:** SEBI plays a major role in regulating stock exchanges by ensuring that they function in an orderly, efficient, and transparent manner. It monitors the activities of exchanges to prevent malpractices such as price manipulation and insider trading. SEBI establishes guidelines for the listing of securities, ensuring companies meet disclosure requirements that promote transparency. It also ensures that trading practices follow established norms, reducing systemic risks and ensuring fair access for all investors. By regulating market participants, SEBI promotes trust and liquidity in the stock exchanges.

3. **Regulation of Intermediaries:** SEBI is responsible for registering and regulating the working of various intermediaries such as stock brokers, sub-brokers, share transfer agents, merchant bankers, underwriters, portfolio managers, and investment advisors who are involved in securities market activities.

4. **Supervision of Market Entities:** SEBI registers and regulates the activities of entities like depositories, their participants, custodians of securities, foreign institutional investors, and credit rating agencies in the capital market.

5. **Regulation of Investment Vehicles:** SEBI regulates various investment vehicles such as venture capital funds, collective investment schemes, and mutual funds to ensure they operate transparently and protect investors' interests. It sets guidelines for the management, structure, and operations of these funds to maintain fairness and accountability. SEBI monitors the disclosure of investment strategies, performance, and risks associated with these funds, helping investors make informed decisions. Additionally, it ensures that fund managers adhere to fiduciary responsibilities and act in the best interest of the investors. By regulating these vehicles, SEBI promotes investor confidence and contributes to the growth of the financial markets.

6. **Support for Self-Regulatory Organisations:** SEBI encourages and regulates Self-Regulatory Organisations (SROs) to enhance the efficiency and integrity of the securities market. SROs are responsible for enforcing rules and regulations among their members, ensuring compliance with market standards. By empowering SROs, SEBI ensures that market participants adhere to ethical practices and maintain high standards of professionalism. SEBI monitors these organisations to prevent conflicts of interest and ensures that they contribute positively to market development. Additionally,

SROs play a key role in dispute resolution and investor protection, helping maintain a fair market environment.

7. **Prevention of Unfair Practices:** SEBI plays a crucial role in maintaining the integrity of the securities market by prohibiting fraudulent and unfair trade practices. It actively monitors market activities to detect and prevent manipulation, such as price rigging, insider trading, and misleading information dissemination. SEBI enforces strict regulations against practices like front-running, circular trading, and other deceptive schemes that undermine investor confidence. Through surveillance, investigations, and penalties, SEBI deters such practices, ensuring a level playing field for all market participants. It also educates investors about potential risks and unethical practices.

8. **Investor Education:** SEBI promotes investor education and provides training to intermediaries in the securities market to enhance market awareness and professionalism.

9. **Prevention of Insider Trading:** SEBI takes strict action to prevent insider trading, where individuals misuse confidential information to gain an unfair advantage in trading.

10. **Regulation of Mergers and Acquisitions:** SEBI regulates mergers and acquisitions (M&As) to maintain transparency and fairness in the process. It ensures that all parties involved disclose relevant information to shareholders, enabling them to make informed decisions. SEBI's guidelines require fair pricing during takeovers to prevent manipulation or exploitation of minority shareholders. The regulator also mandates that offers be made in a transparent manner and within a specified timeline. It monitors compliance with regulations to avoid any unfair advantage during the acquisition process. Through these measures, SEBI protects investor interests and ensures the proper functioning of the market during corporate restructuring activities.

11. **Market Surveillance:** SEBI collects information, conducts inspections, and performs audits of stock exchanges, mutual funds, intermediaries, and SROs to ensure compliance with regulations.

12. **Execution of Delegated Powers:** SEBI performs functions and exercises powers delegated by the Central Government under the Securities Contracts (Regulation) Act, 1956.

13. **Fee Collection:** SEBI collects fees and other charges from market participants to fund its operations and development initiatives.

14. **Research and Development:** SEBI conducts research to increase the efficiency and stability of the securities market by analysing trends, emerging risks, and global developments. The research helps in identifying areas that need regulatory improvements or new regulations. SEBI also collaborates with academic institutions, financial experts, and other stakeholders to gather insights and data that aid in market development. By studying market behaviour and investor trends, SEBI formulates policies to address

issues like market volatility and investor protection. Additionally, research supports SEBI's efforts to monitor financial innovations and adopt global best practices.

15. **Additional Functions:** SEBI performs any other functions prescribed under its mandate to maintain an efficient securities market.

16. **Information Exchange:** SEBI can request or share information with other agencies as necessary for effective regulation and market efficiency.

17. **Civil Court Powers:** In certain cases, SEBI is vested with powers akin to those of a civil court under the Code of Civil Procedure, 1908. These powers enable SEBI to take crucial actions such as ordering the discovery and production of books of accounts and other relevant documents. Additionally, SEBI has the authority to summon individuals and examine them under oath to gather necessary information. It also holds the power to inspect books, registers, and various other documents of entities at designated locations, ensuring thorough scrutiny and compliance with regulatory standards. These powers empower SEBI to effectively enforce regulations and maintain integrity in the securities market.

Through these comprehensive functions, SEBI ensures the orderly growth of the securities market, protects investor interests, and maintains trust in India's financial system.

Recap

- SEBI was established in 1988 and granted statutory powers in 1992
- Initially, stock exchanges were regulated by the Government of India under the Securities Contract (Regulation) Act, 1956
- Controller of Capital Issues (CCI) controlled primary capital markets until deregulation in 1992
- SEBI Board consists of six members including Chairman
- SEBI has four main operational departments-Primary Market, Secondary Market, Issue Management, and Intermediaries
- SEBI regulates stock exchanges, supervises market intermediaries, oversees mutual funds, prevents insider trading, and ensures market integrity
- SEBI encourages technological advancements, market awareness, and a competitive environment to facilitate smooth functioning and growth of financial markets

- SEBI exercises powers like inspecting documents, summoning individuals, and regulating mergers and acquisitions, with civil court authority in specific cases

Objective Questions

1. When was the SEBI established as a non-statutory body?
2. In which year did SEBI gain statutory powers?
3. Which ministry oversees the operations of SEBI?
4. What was the role of the Controller of Capital Issues (CCI) before its abolition in 1992?
5. Which act initially governed the regulation of stock exchanges in India?
6. How many members are there in SEBI's statutory board structure?
7. Which department of SEBI oversees the issuance of new securities in the primary market?
8. What is SEBI's primary duty related to investors?
9. Which market practice is SEBI responsible for preventing to maintain trust in the securities market?
10. What powers does SEBI have under the Code of Civil Procedure, 1908?
11. Which year marked the delegation of powers under the Securities Contracts (Regulation) Act, 1956, to SEBI?
12. Name one type of intermediary regulated by SEBI.

Answers

1. 1988
2. 1992

3. Ministry of Finance
4. Regulated the issuance and pricing of securities by companies
5. Securities Contract (Regulation) Act, 1956
6. Six members
7. Primary Market Department
8. Protecting the interests of investors in securities
9. Insider trading
10. Powers to summon individuals, inspect books and documents, and examine individuals under oath
11. 1994
12. Stock brokers

Assignments

1. Explain the historical background and evolution of SEBI in India.
2. Discuss the structure of SEBI as outlined in the SEBI Act.
3. What are the primary functions of SEBI in regulating the securities market?
4. How did the abolition of the Controller of Capital Issues (CCI) impact the regulation of capital markets in India?
5. Describe the departments within SEBI and their specific responsibilities.

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Model Question Paper- set-I

FOURTH SEMESTER - BA ECONOMICS EXAMINATION

DISCIPLINE SPECIFIC ELECTIVE - B21EC02DE - MONEY AND BANKING

(CBCS - UG)

2023-24 - Admission Onwards

Time: 3 Hours Max Marks: 70

Section A - Objective Type Questions

Answer any 10 questions. Each question carries 1 mark

(10 X 1=10 Marks)

1. Who is associated with the equation of exchange?
2. What material is used to make banknotes in India?
3. Name the two primary functions of commercial banks.
4. What is the other name of secondary deposit?
5. Which banking method provides round-the-clock service?
6. What type of account does a credit card create for the cardholder?
7. What does the steady decline in the value of money refer to?
8. Which commission recommended the establishment of the Reserve Bank of India?
9. What are financial derivatives?
10. Which institution is responsible for conducting monetary policy in India?
11. Define financial institutions
12. Name the two categories of banking institutions.

13. Define capital market.

14. When was SEBI established as a non-statutory body?

15. Which market is associated with the sale of new securities?

Section B - Very Short Answer

Answer any 10 questions. Each question carries 2 marks

(10X2=20 Marks)

16. What do you mean by the transaction approach?

17. What do you mean by fiat money?

18. Name the parties to a promissory note.

19. What is CRR?

20. Distinguish between internet banking and mobile banking.

21. What is meant by telephone banking

22. What is a debit card? Name any two commonly used debit cards in India.

23. Why is the RBI known as the banker to the banks?

24. What is the role of RBI as a note issuing authority?

25. Distinguish between CRR and SLR.

26. What is IPO?

27. List out the components of the financial system.

28. What are the major classification of the financial market?

29. Write a note on SEBI.

30. Who are retail investors?

Section C - Short Answer

Answer any 5 questions. Each question carries 4 marks.

(5X4=20 Marks)

31. Write a note on Monetary Standards.

32. Write a short note on balance sheet of a commercial bank.

33. Discuss the features and benefits of Kisan Credit Card.

34. Discuss the key functions of the Reserve Bank of India (RBI).

35. Explain the structure and management of the Reserve Bank of India (RBI)

36. What are the main objectives of monetary policy in India.

37. Write a note on Non-Banking Financial Institutions.

38. Explain the functions of a capital market.

39. What are the primary functions of SEBI in regulating the securities market?

40. Explain the historical background of SEBI.

Section D - Long Answer/Essay

Answer any 2 questions. Each question carries 10 marks.

(2X10=20 Marks)

41. Elucidate the Indian Currency System.

42. Explain the process of credit creation in banking system.

43. Explain the concepts, features, and significance of telephone banking, internet banking, and mobile banking in the digital era.

44. Define the financial system. Explain its features and components.

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Name : …….....

Model Question Paper- set-II

FOURTH SEMESTER - BA ECONOMICS EXAMINATION

DISCIPLINE SPECIFIC ELECTIVE - B21EC02DE - MONEY AND BANKING

(CBCS - UG)

2023-24 - Admission Onwards

Time: 3 Hours Max Marks: 70

Section A - Objective Type Questions

Answer any 10 questions. Each question carries 1 mark

(10 X 1=10 Marks)

1. What is a metallic-based system?

2. Who restated the classical Quantity Theory of Money in 1956?

3. According to Friedman, what is the primary role of money in the economy?

4. What is a primary deposit?

5. Give any two examples of negotiable instruments.

6. Name the parties to a cheque.

7. What does PIN stand for?

8. Which technology makes core banking user-friendly and efficient?

9. What does the term MSF stand for?

10. What is meant by priority sector lending?

11. Which bank was nationalised into the State Bank of India in 1955?

12. Define Insurance companies.

13. What is called the Treasury bill market?

14. Which ministry oversees the operations of SEBI?

15. What does FPI stand for?

Section B - Very Short Answer

Answer any 10 questions. Each question carries 2 marks

(10X2=20 Marks)

16. Define High-Powered Money.

17. Define Index Number.

18. What are the essential characteristics of a promissory note?

19. Write a note on credit multiplier.

20. Write any four applications of smart cards.

21. Write any two advantages and disadvantages of NEFT.

22. What is the importance of IFSC?

23. What is meant by open market operations?

24. Why did the government nationalised banks in India?

25. What are the key objectives of banking sector reforms in India.

26. Distinguish between savings deposit, terms deposit, and recurring deposit.

27. Briefly explain the two categories of banking institutions.

28. Write down any two functions of the financial market.

29. Which are the four main operational departments of SEBI?

30. Write about institutional investors.

Section C - Short Answer

Answer any 5 questions. Each question carries 4 marks

(5X4=20 Marks)

31. Explain the monetarist approach to the demand for money.

32. Explain various types of loans granted by banks.

33. Define RTGS. Discuss the advantages and disadvantages of RTGS.

34. Distinguish between repo and reverse repo rate.

35. Describe the history of the early phase of banking in India-up to 1947.

36. Discuss the key recommendations of the Narasimham Committee(1992) on the banking sector.

37. Describe various functions of commercial banks.

38. What are negotiable instruments? Explain the characteristics of negotiable instruments.

39.Write a note on insurance companies.

40. Write about Foreign Portfolio Investors.

Section D - Long Answer/Essay

Answer any 2 questions. Each question carries 10 marks

(2X10=20 Marks)

41.Graphically explain the Keynesian approach to the demand for money.

42. Explain the structure and functions of SEBI.

43. Explain the different types of banking cards along with their features and uses.

44. Explain the functions and features of the Indian money market.

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Name : …….....

Model Question Paper- set-I

FOURTH SEMESTER - BA ECONOMICS EXAMINATION

DISCIPLINE CORE – 04 - STATISTICS FOR ECONOMICS

(CBCS - UG)

2023-24 - Admission Onwards

Time: 3 Hours Max Marks: 70

Section A - Objective Type Questions

Answer any 10 questions. Each question carries 1 mark

(10 X 1=10 marks)

1. Name two commonly used price indices in economics.
2. In a scatter diagram, if all points lie on a straight line from the lower left to the upper right, what type of correlation does it indicate?
3. Which index number formula satisfies both the time reversal and factor reversal tests?
4. What is the probability of an impossible event?
5. Which measure of central tendency is most commonly referred to as 'average'?
6. What is CPI?
7. What is the square of the Standard Deviation called?
8. What is the probability of getting a 3 on a fair six-sided die?
9. Name one type of non-probability sampling where participants recruit others from their network.

10. Which graphical method is commonly used to determine the correlation between two variables?

11. What is the main risk associated with judgment sampling?

12. Which measure of central tendency is least affected by extreme values?

13. Who first introduced the term regression?

14. Name two types of random variables.

15. What is a dependent variable?

Section B - Very Short Answer

Answer any 10 questions. Each question carries 2 marks

(10X2=20 marks)

16. What is Coefficient of Variation (CV)?

17. What is an index number?

18. Define arithmetic mean and write its formula.

19. Why is Fisher's index number considered ideal?

20. Define perfect negative correlation.

21. Write a very short note on convenience sampling.

22. What is Karl Pearson's Coefficient of Correlation?

23. Define sampling.

24. Write a very short note on regression analysis.

25. Define probability.

26. What is an independent variable in regression analysis?

27. Define the probability mass function (PMF).

28. Write a very short note on the Principle of Least Squares.

29. What are mutually exclusive events?

30. Define the Time Reversal Test.

Section C - Short Answer

Answer any 5 questions. Each question carries 4 marks.

(5X4=20 marks)

31. Explain the concept of conditional probability and its applications with examples.

32. Explain the different tests used to evaluate the accuracy of index numbers.

33. A bag contains 6 red balls and 4 blue balls. Two balls are drawn at random one after the other without replacement. What is the probability that both the balls are red?

34. The following table shows the number of hours studied and the corresponding test scores of 5 students :

Hours Studied (X)	Test Score (Y)
2	50
4	60
6	70
8	80
10	90

Calculate the correlation coefficient (r) between the number of hours studied (X) and the test scores (Y). Based on the value of r, determine whether the correlation is positive, negative, or zero.

35. A coin is flipped 5 times. A success is defined as getting heads on a flip. Find the mean and variance of the number of successes.

36. Discuss the properties of regression lines.

37. Compare and contrast Consumer Price Index (CPI) and Wholesale Price Index (WPI) in India.

38. Define standard deviation. Explain the merits and demerits of standard deviation.

39. Discuss in detail about cluster sampling.

40. From the following data, calculate Paasche's Price Index Number for the year 2023 using 2022 as the base year.

Commodity	Price (2022)	Price (2023)	Quantity (2022)	Quantity (2023)
X	15	18	20	22
Y	10	12	30	28
Z	25	30	15	18
W	40	45	10	12

Section D - Long Answer/Essay

Answer any 2 questions. Each question carries 10 marks.

(2X10=20 marks)

41. Discuss the features, advantages, and limitations of non-probability sampling methods.

42. Find the regression coefficients of P on Q and Q on P from the data provided in the table. Also, determine the regression equations.

P	12	8	12	8	10
Q	8	4	12	6	10

43. A survey was conducted by a market research agency, and 250 people were interviewed. The frequency distribution below provides the ages of the individuals surveyed. Calculate the mean age.

Age Group (yrs)	90-99	80-89	70-79	60-69	50-59	40-49	30-39	20-29	10-19
Frequency	1	3	5	15	45	60	55	50	16

44. A company wants to analyse whether advertising expenditure influences sales revenue. The following table provides data for 8 months on advertising expenditure (in ₹1000s) and corresponding sales revenue (in ₹1000s):

Month	Advertising Expenditure (X)	Sales Revenue (Y)
1	10	200

2	15	220
3	8	180
4	20	260
5	18	240
6	12	210
7	25	300
8	22	280

a. Compute the Pearson correlation coefficient (r) to determine the strength and direction of the relationship between advertising expenditure and sales revenue.

b. Interpret the correlation coefficient and explain whether advertising expenditure has a significant impact on sales.

c. If the correlation is strong, can the company expect an increase in sales revenue if they increase their advertising budget?

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Model Question Paper- set-II

FOURTH SEMESTER - BA ECONOMICS EXAMINATION

DISCIPLINE CORE – 04 - STATISTICS FOR ECONOMICS

(CBCS - UG)

2023-24 - Admission Onwards

Time: 3 Hours Max Marks: 70

Section A - Objective Type Questions

Answer any 10 questions. Each question carries 1 mark

(10 X 1=10 marks)

1. Which index is used to measure changes in the selling prices received by domestic producers?
2. If all points on a scatter diagram lie perfectly on a straight line, what type of correlation exists?
3. What is the primary purpose of an index number?
4. What is the range of the correlation coefficient?
5. What is the empirical relationship between Mean, Median, and Mode?
6. Which test ensures that an index number remains independent of units of measurement?
7. Who introduced the concept of standard deviation?
8. What is the formula for conditional probability?
9. What is the term used for the entire group that you want to draw conclusions about in a statistical investigation?
10. What are the two major methods of measuring correlation?

11. Which non-probability sampling method is often used for pilot studies due to its low cost and ease of use?

12. How is the Coefficient of Variation (CV) calculated?

13. How many variables are involved in simple linear regression?

14. What is the mean formula for a binomial distribution?

15. Who first introduced the term regression?

Section B - Very Short Answer

Answer any 10 questions. Each question carries 2 marks

(10X2=20 marks)

16. Define Median.

17. Why is selecting a suitable base period important in constructing index numbers?

18. What is the significance of the Coefficient of Quartile Deviation?

19. Define the Time Reversal Test.

20. Write a very short note on multiple correlation.

21. What is stratified random sampling?

22. What is the interpretation of a correlation coefficient value of -0.8?

23. Explain the concept of quota sampling.

24. What is the regression coefficient?

25. State any two axioms of probability.

26. Define Line of best fit.

27. Define correlation coefficient.

28. What does the sign of a regression coefficient indicate?

29. What is the probability density function (PDF)?

30. Define WPI.

Section C- Short Answer

Answer any 5 questions. Each question carries 4 marks.

(5X4=20 marks)

31. Discuss the various uses of correlation.

32. Describe the difference between Time Reversal and Factor Reversal Tests.

33. Explain the various uses of index numbers.

34. Two judges in a dance competition rank the 10 participants as follows:

Participant	Judge 1 Rankings (X)	Judge 2 Rankings (Y)
1	1	3
2	2	2
3	3	1
4	4	5
5	5	4
6	6	7
7	7	6
8	8	9
9	9	8
10	10	10

Calculate Spearman's Rank Correlation Coefficient (ρ) between the rankings of Judge 1 (X) and Judge 2 (Y).

35. Discuss the properties of a binomial distribution.

36. The following data pertains to the scores in subjects X and Y in a certain test. Mean scores in X = 65.3 , Mean scores in Y = 72.4 , standard deviation of scores in X = 8.7 , and standard deviation of scores in Y = 14.2 . The coefficient of correlation between scores in X and Y is 0.56. Estimate the score in Y for a candidate who scored 70 in X.

37. Discuss the uses and limitations of index numbers in economic decision-

making.

38. Below are the prices of 1 kg of wheat flour for the first six months. Find the Range and Coefficient of Range.

Month	January	February	March	April	May	June
Price/kg	30	28	35	32	40	38

39. Describe the process of systematic sampling.

40. What are the properties of the correlation coefficient?

Section D - Long Answer/Essay

Answer any 2 questions. Each question carries 10 marks.

(2X10=20 marks)

41. Discuss the various methods of probability sampling, highlighting their features, advantages, and limitations.

42. Discuss the regression coefficients of x on y and y on x. Explain the key properties of regression coefficients.

43. Suppose you are a coach and you want to evaluate the performance of two cricketers in a series of tests.

Batter	**Test 1**	**Test 2**	**Test 3**	**Test 4**	**Test 5**
John	85	88	86	87	89
Robin	92	78	85	90	80

Determine which of the two cricketers, John or Robin, is more consistent in their scores.

44. The average score on a science test is 70, with a standard deviation of 4. If the scores are normally distributed, how many students in a class of 100 scored below 65 or above 75?

സർവ്വകലാശാലാഗീതം

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