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**UNIT-I**

**CONCEPTS AND FUNCTIONS OF MONEY**

**Introduction**

Money is any commodity accepted by general consent as a medium of economic exchange. It is the medium in which prices and values are expressed, as currency, it circulates anonymously from person to person and country to country thus facilitating trade.

Money is an indispensable element of modern civilization. To lay man, the rupee is money in India, the pound is money in England & the dollar is money in America. However, to an economist, the rupee, the pound & the Dollar are Different units of money. Hence, the question remains – what is money.

**Definition of money:**

In fact, it is difficult to define money in a strike sense. Money is a social convention. We accept money as a medium of payment because we accept others to accept it from us.

Different viewpoints have been adopted by difference economics by definition of money.

According to Seligman, “Money is a thing that possesses general acceptability.”

On the other hand, Economist Walker has defined money, as “Money is what money does.”

Prof. Price says, “Money means coins of metal”.

**Functions of money.**

* **A medium of exchange**

Money acts as a medium of exchange which can be used for buying and selling goods and services. This transfer of money from buyer to seller allows the transaction to take place. It plays a mediator role between purchases and sales. It replaced barter system with money exchange system.

* **A unit of account**

Money is the common standard for measuring relative worth of goods and services. Money is used to designate the prices of goods and services. Any item that is generally accepted as payment for goods and services is also the obvious choice for denominating the prices of those goods and services.

* **A storage of value**

Money’s value can be retained over time and a convenient way to store wealth. Money can be used to transfer purchasing power from present into the future.

* **A standard of deffered payment**.

Money is used to designate future payments, such as those for loan repayments. The standard of deffered payment is a natural result of the standard unit of account and store of value functions of money.

**Features of money.**

* **Durability.**

Durability means that the item must be able to exist for a long time without deterioration and to withstand being used repeatedly.

Durability is critical for money to perform the related functions of medium of exchange and store value. Items that are considered currency, coins, and paper bills used as money meet this requirement. In modern days, money is made out of paper, metal and plastic which make money long lasting.

* **Portability**

Portability means that individuals are able to carry money with them and transfer it easily to other individuals.

This is why coins and paper money have historically proved popular. In modern days, money is carried from one place to another with less effort where a wallet can carry any type of money including note, coins and debit cards.

* **Divisibility.**

Divisibility means that the money can easily be divided into smaller units of value. When people used stones and tobacco as money, they were not able to divide those into small pieces in a standard form where they used it as a whole or divided into small pieces but it was lacking standardization. In modern days, people have notes and coins from low values to high values where they are used to divide money into small units of account.

* **Uniformity**

Uniformity means that all versions of the same denomination of currency must have the purchasing power.

* **Limited Supply**

Limited supply means that restrictions on the amount of money in circulation ensure that values remain relatively constant for the currency.

Currently, respective country’s Government has the responsibility to control an adequate money supply to market based on their monetary policies.

* **Acceptability**

Acceptability means that everyone must be able to use the money for transaction. Money is universally accepted anywhere in the world as a universal means for transaction.

**Various Component Of Money Supply.**

In India, to calculate the supply of money, four components are included in the supply of money. They are presented as M1, M2, and M3 & M4. This classification has been applied by the RBI since April 1977. But before 1968, RBI used only M and M1 to measure the supply of money. This concept provided very limited/narrow meaning to the supply of money. This concept provided very limited meaning to the supply of money. Therefore, in April,1968 the other measurements and components were declared by the RBI they are called aggregate monetary resources according to the recommendation of second working group, RBI has included four components to calculate supply of money in an economy they are known as under.

**(I) M1:**

M1 is the first components of supply of money. It includes three other sub components as under:

(A) Total quantity of currency notes with the people:

This includes currency notes & coins. It also indicates the supply of currency money.

(B) Amount of demand deposit:

This includes the demand deposit of commercial bank &co operative banks.

(C) Other deposited with RBI:

This includes the current account of deposit of the World Bank, IMF & other banks with the RBI.

**(II) M2:**

In M2, M1 plus post office saving deposits are included.

**(III) M3:**

M3 is a third component. It includes M2 plus time deposits of commercial & co-operative banks.

**(IV) M4:**

M4 is a fourth component. It includes M3 plus total post office deposits.

FM1+M2+M3+M4. It means:

1. Currency notes & coins with the people.

2. Demand deposits with commercial &co operative banks.

3. Other current account deposits with RBI + post office saving bank deposits + time deposits with banks + total post office deposits.

Thus, the four components maintained above are totals in order to measure the supply of money in India.

**Importance of different components of money supply**

Since independence & specially after starting economical planning in India, there has been a continued & sizable increase in the supply of money in our country. The supply of money has been an important & effective factor for prize rise & inflation during the period of planning.

In the first phase of planning, the banking section of our country did not develop, so hard case (M1) was being consumed in the dealings/trading/transaction. The only M1

was significant component. As the banking sector went on developing, credit money was being used instead of M1 reduced. This is the change of economy in our country, yet in comparison to other developed country. 70% trading is done, even today, through M1 and 30% transactions are settled down through M2 & M3 in our country. While only 20% M1 is used in developed countries and 80% transactions are settled down through M2 & M3. Here, follows the reason for it:

1. As we stated above, the banking sector has not developed in our country as it has been in developed countries.

2. The rate of taxes are comparatively vary high in our country:

As a result there is great amount of black money in our country. Naturally, black money is to be paid only through hire cash means M1. The Reserve Bank of India is giving now more importance to M3. it helps in shaping and framing credit policy. For this it is necessary to spread the use of banking money through ATM, online banking etc. instead of cash money it can be said that in total supply of money in India

**Quantity theory of money related to value of money which presumptions are made in it.**

**Introduction:**

Value of money means purchasing power. Purchasing power is based upon the price of Goods and services. Value of money is determined by the market forces of demand and supply. There is inverse relationship between purchasing power or value of money and price. The tool used for measuring the value of money is called price index number. If price index number is decreased that means there is decrease in general price level. This means the value of money is increased.

**Meaning and Definition of quantity theory of money:**

The value of commodity is determined by its demand and supply, similarly the value of money is also determined by the demand and supply of the money. If other factors remain constant and if demand of money increases, value of money also increases and if the supply of money increases the value of money decreases.

“The value of money changes inversely and the price level directly of the changes in the quantity of money.”

- R. S. Sayers

Thus main essence of the quantity theory of money is that “Quantity of money has direct relation with price level and inverse relation with value of money.”

**Assumption of the Quantity Theory/ Conditions of the theory:**

For the proper application of theory, all other factors must remain constant or unchanged. All these other factors are called assumptions. These are given below:

**Demand of money should remain constant:**

Quantity theory of money works properly only when the demand of money remains unchanged. In other words, the factors affecting the demand of money are assumed to be constant. The factors affecting demand of money are population, production, habit and nature of people, use of money etc.

**Volume of transactions:**

For the success of the theory it is assumed that the extent of deals remains constant, this means that transactions to be performed by money, must remain same. The volume of transactions to be effected by employment of the factors of production, volume of new securities and number of times they are sold for money. Technique of production, efficiency of management et.

**Velocity of circulation of credit money:**

The supply and velocity of circulation of credit money must also remain unchanged. On the basis of cash deposits in commercial banks, credit money is created. The proportion between the money in circulation and the credit money should remain constant so that the theory can properly work.

**Velocity of money:**

Velocity of circulation of money we mean the speed with money circulates hand to another hand for purchasing goods, within specific period. As per this assumption of the theory, velocity should remain constant.

**Volume of Barter transactions:**

The extent of deals made without the help of money should also remain constant, it means there is no change in the volume of barter transaction of the community, i.e. the volume of transaction without using money remains the same.

**Money should not be stored:**

All the coins and notes issued once should be in the circulation. If in between certain portion of money is stored this theory does not prove proper.

**Fisher’s quantity theory of money:**

Prof. Irving Fisher has expressed the relationship between quantity of money and its value. All the economists who have presented the quantity theory of money have accepted the fact that the value of money is determined by the quantity of money. Prof. Fisher have explained the quantity theory of money by the following equation which is also known as ‘equation of exchange’

P = M/T

Where, P = General Price level

M = Quantity of money

T = Total volume of transactions

In above equation velocity of money is not taken into account. Hence, economist presented new equation.

P = MV / T

MV = PT

Where, V = Velocity of money

In above equation demand of money is presented by PT and quantity of money is presented by MV in which T and V are constant. However, this equation of exchange included only currency money and left out bank money. So it is called this equation is also imperfect because now-a-days the credit money also functions as medium of transaction which is not consider in this equation. For actually measuring the value of money properly, credit money and its velocity must be considered.

Prof. Fisher gives explanation of theory of transaction of quantity by the following equation.

PT = MV + M’T’

P = MV + M’V’/T

Where, M’ = Credit money / Bank money

V’ = Velocity of money

In above equation two fundamental points in the equation are given.

1. P, price level changes because the quantity of money changes.

2. The price level changes directly and in the same proportion as the quantity of money (m). E.g. if the quantity of money increased by 50 percent, price level (p) will also increase exactly by 50 percent.

**Cash balance equation of Cambridge:**

To prevent the defects of the Fisher’s theory, some economists made some additions and changes to it to give it a new form. This was done by Cambridge economists like Prof. Marshall, Pigou, Keynes etc.. The new equation presented by them is known as Cambridge equation. It is also known as cash balance approach.

The cash balance approach emphasis the “Store of value function of money and not the medium of exchange function”. This theory is related with quantity of money which people desire to keep it in the form of cash for a given period of time.

The theory presented by Fisher is more popular in America, while the theory presented by Cambridge economist is more popular in Europe.

**Demand for money in cash balance version**:

The community’s demand for money is conceived of as a aggregate cash balance or money holdings of all individuals at a given moment of time. As Fisher’s theory is based on supply of money, similarly Cambridge theory is based on demand of money. There are three main reasons for holding cash balance.

a) People like cash to buy goods and services that is to conduct day to day transaction. This is known as transaction motive for holding cash.

b) People like to keep cash as measure of protection in the event of emergencies. This is known as precautionary motive for holding cash.

c) People hold cash for speculative purpose that is to earn profit as a result of fluctuations in the rate of interest.

In this manner the total cash on hand kept by an individual, institution or the government to fulfill different motives, which is called total demand of money. It is known as liquidity preference.

**Supply of money in cash balance version:**

The supply of money is composed of all the cash and deposits subject to withdrawal of cheques.

**Cash balance equation:**

The relationship between price level and supply of money has been expressed by the Cambridge economists in the form of equations known as cash balance equations or the Cambridge equations. We discuss below the equation as presented by Pigou :

P = KR / M

Here,

M = Total quantity of money

P = Price level of goods

R = Total real income of nation

K = That portion of real income which people want to keep in the form of cash.

It is clear from this equation that P, the purchasing power will vary directly with K or R and inversely with M. This means that price level will vary inversely with K or R and directly with M. Therefore, if P is taken to represent the price level as in Fisher's equation, then Pigou's equation can be restated as.

P = M / KR

M = PKR

In short, as per the opinion of Cambridge economist there is inverse relation between demand of money and price. While demand of money and price has direct relation. So, when other factors remain constant and demand of money increases, then there is decrease in price level and value of money increases. Contrary to it, when the demand of money gets reduced, then there is increase in price level and value of money gets reduced.

**Unit 2 Indian Financial System**

**Introduction**

It is generally believed that the person or the institution, which accepts the deposits or lends money, is called 'Bank', but this explanation is not proper from the viewpoint of economics and banking system. As we know, many insurance companies accept deposits and the same way, money - lenders lend money. Nevertheless, they are not called bankers. Money - lenders lend only. They don't lend after accepting the deposit, while banker or bank is a person or institute that accepts / receives deposits and lends also.

**Definition and Meaning of the Bank:**

Defining bank, Crowther says," The bank is an institution, which collects deposits from the people / different sources, who have spare /surplus money or who save, and then lends to them, who need it.

'Bank' has been defined Clause No.3 of Negotiable Instrument Act of India as under:

"The word 'banker' includes the person or company or corporation, which functions as the banker".

The Banking Act, 1949 defines, "A banking company is one, which transact the business of banking, which means the accepting for the purpose of lending or investment of deposit of money from the public, repayable on demand or otherwise by cheque, draft or order".

**Importance of Bank:**

**[1] Banks makes Financial Transaction Safe:**

It is natural that cash transactions are comparatively unsafe, while banking has made monetary transactions safer and speedy. Moreover, transactions are mentioned and noted in the books of account of the bank. This is also one type of documentary safety.

**[2] Bank Satisfies Monetary Needs:**

The banks accept deposits and lend them also. The banking system tries to satisfy monetary needs / financial requirement of agriculture, trade, industry and service sector. Its important function is Credit Creation.

**[3] Bank helps to reduce unemployment and poverty:**

These days, banks provide loans and advances for the purchase of various consumer items. Thus, the banking promotes the production and sale of such articles. The banking provides loans and advances to unemployed people for self employment. Thus, it plays an important role, firstly for the removal of unemployment and ultimately, the poverty.

**[4] Bank makes economic development possible:**

Targets or goals are fixed / decided in different sectors of economy for development. Naturally, money is required to achieve such targets. Here, bank comes to help / assist.

**[5] Bank promotes international trade:**

These days, no country may remain aloof (separate) or totally independent. All the countries depend upon one another. Mostly, each and every country is involved in export and import. Bank arranges for finance /foreign exchange for international trade.

**Types / kinds of Banks**

**The Commercial Bank:**

The bank, which lends to trade, commerce and industry particularly with a view, to earning profit, is a commercial bank. It insists for security for their business safety. They discount exchange bills and Hundies also. Our nationalized banks are such commercial banks. State Bank of India, Bank of India, Punjab National Bank etc. are the examples of commercial banks.

**The Industrial Bank:**

These banks satisfy the long term finance need of trade and industry. They provide finance to them for purchasing machineries and capital goods / assets. Such banks are helpful to companies for the issue of shares and debentures. IDBI and ICICI are the examples of such bank.

**The Agricultural Bank:**

The agricultural field requires short term, medium term and long term financial needs. Such banks provide such facilities in agricultural field and rural areas. The co-operative banks are playing a great role in the agricultural field and rural areas. The co-operative banks are playing a great role in the agricultural field of India. The Land Development Bank, provides long term monetary needs. The Region Rural Bank pay attention to the need of agricultural field in our country. **The Savings Bank:**

The bank, which performs the function of collecting small savings of middle class people, is a saving bank. Such banks are not involved / engaged in lending, so they may not be called 'Bank' in a strict sense. The post office collects savings in our country. They are called 'Post - office saving Banks'.

**The Foreign Exchange Bank:**

The bank, which promotes and makes foreign trade easier and smoother is a 'Foreign Exchange Bank'. It converts the currency of one country into currency of another country as per requirement. They lend for foreign trade also. They perform function as commercial banks also. The Exim Bank is the example here.

**The Central Bank:**

These days, each and every country has a central bank. Profit making is not a primary object of the Central Bank. The Central Bank issues /mints currency notes and coins on behalf of the government. It controls the supply and demand of the money in country. It implements financial policy of the government. The Bank of England and The Federal Bank of America are Central banks of England and America respectively. The Reserve Bank of India is the Central Bank of country. As we know, the RBI was established in April, 1935 in our country, as the Central Bank and with the passage of time, the RBI was nationalized in 1949.

**The International Bank:**

The bank of which the function is not limited to one particular country is an international bank. The World Bank and The International Monetary Fund [IMF] are such institutes. Such banks / institutes were established for rebuilding / reconstructing / re-habilitation of the countries affected in the world war-II, and it aims at the economic development of under-developed or developing countries. Moreover, it solves the problems of monetary transactions / exchange among different countries.

**Money Lending Business/ Shroff / Deshi Bank**

The banking is an age-old concept in our country. Of course, there is no doubt that the western type / systematic banking has developed after freedom in India. Many times, money - lenders and shroffs are considered to be bank / bankers, but there is difference between them. Money-lenders lend only, so they are not 'banker' in a strict sense, while shroff accept deposit and lend also, so they can be termed as bankers.

**Commercial Banks**

A Commercial bank is a profit seeking business firm dealing in money or rather claims to money. The greater part of money supply is the direct consequence of the profit seeking or money creating activities of commercial banks.

**Functions Of Commercial Banks.**

The major functions of commercial banks can be classified as follows:

**Primary Functions:**

**1. Accepting deposits:**

The commercial banks cannot run its business on its own capital, therefore deposits are accepted by the banks in various forms. These deposits are called 'Primary Deposits'. The important and basic types of deposits are as under:

* **Current Account Deposits:**

This account is operated by traders, businessmen and industrialists. Customers have the facility to deposit and withdraw from such account as many times as they wish. No interest is paid on such accounts. Customers are given overdraft facility on this account.

* **Saving Account Deposits:**

Such accounts are opened / preferred by salaried / fixed income people. It can be opened with a nominal / small amount also. It earns interest less than fix deposits. Interest is calculated as per the system of the bank and account holder is issued a passbook and a cheque book also. There may be different types of saving deposits/recurring deposits, monthly income, schemes and minor saving deposits.

* **Fixed Account Deposits:**

In such accounts, money is deposited for a fixed period of time. On maturity the investor is paid the principal plus the interest for a given period. The rate of interest is as per the duration of the account.

* **Recurring Deposit Account:**

Recurring deposit account is beneficial for small savers. Here the account holder has to deposit a given amount every month and it is deposited for a given period. At time of maturity principal and interest earned is paid to account holder. The interest rate on recurring deposit is higher than saving account deposit but lower than fixed account deposit.

**2. Advancing loans:**

The second important function of a bank is loans and advances. As mentioned above, the commercial banks collect funds / deposits in various forms from people / consumers. Banks pay them interest at a lower rate and provide loans and advances at a higher rate of interest. Thus, banks earn profit.

While sanctioning loans and advances, the bank considers the financial and business capacity of the applicant. Moreover, the bank considers the liquidity of its own deposits. Bank should provide loans and advances such a way that it may pay interest to its depositors, it may run it managerial expenditures and it may earn reasonable profit. The loans and advances may be classified as under depending upon the time limit.

* **Cash Credit:**

Banks provide loans for a given period on the security of shares, debentures and movable and immovable properties. This is the most common method of advancing loans.

* **Loans and advances:**

Under it banks provide loans and advances to its customers on adequate securities. Such amount of loans and advances are deposited in the account of the borrower and borrower can withdraw the amount as and when he requires. Such facility is given for a certain period.

* **Overdraft:**

Overdraft facility is provided under the current account. The current account holder can withdraw more than the deposit in the account. The overdraft facility depends on the credit of the customers. Such facility is given for short term and emergency purpose.

* **Discounting of bills of exchange:**

Under this method banks provide credit against eligible commercial bills. Seller writes such bills and buyer accepts it. The buyer promises to pay given amount for given period. Such bills are discounted by banks and payment is made to the customer.

**Secondary Functions**

The secondary functions are classified as :

1. **Agency functions:**

Banks act as agents of their customers and render services. The following are the agency functions of the banks:

1. **Collection of payment of cheques, bills of exchange and other letter of credit:**

Banks collects payments of cheques, bills of exchange and other letter of credit deposited by the customer in the bank. Banks act as an agent on behalf of the customer and collects deposits.

1. **Receiving payments for customers:**

Banks also receive rent, interest, dividend etc on behalf of their customer.

1. **Payment on behalf of customers:**

Banks not only receive payments on behalf of their customers but also make payments on behalf of customers in the form of rent, interest, dividends, commission etc.

1. **Transfer of money:**

Banks transfer money from one place to another as directed by their customers. Bank draft, postel and telegraphic transfers are the methods through which such transfers take place.

1. **Purchase and rate of shares of securities:**

Banks purchases and sales shares, securities on behalf of their customers.

1. **Functions of Managers, Trustee and Executer:**

On the direction of customer, bank performs the function of manager, trustee and executer.

1. **Underwriting function:**

Large industrial houses raise capital from market. Banks helps companies to raise money by acting as an under writer.

1. **General Utility Function:**

Besides agency function, banks also perform other services

1. **Locker facility:**

Banks provide locker facility which enables customers to keep valuables like gold, shares, important documents with the banks.

1. **Financial Adviser:**

Banks advise their customers on economic and financial matters.

1. **Referee**

A commercial banks acts as a referee to the financial standing of his customers. This is a very valuable service to businessmen for it enables them to obtain goods and services on credit.

**Credit Creation By Commercial Banks.**

* Banks occupy a special position in the monetary system because of their ability to create credit. According to Sayer, “Banks are not merely purveyors of money, but also in an important sense, manufacturers of money.”
* The credit creation is done by the entire banking system. Therefore it is called as multiple credit creation.
* In a modern economy, a large proportion of the total supply of money consists of banks demand deposits.
* When customer of the bank deposit cash with the bank, it create demand deposit in the name of the customer. Such deposits are known as primary deposits.
* The banks knows from the experience that the money kept in primary deposits are not withdrawn at one go.
* The money is withdrawn in installments. The banks knows that it requires a certain volume of cash to meet these withdrawals. The banks therefore maintain cash reserves to meet these commitments. The remaining amount is used by the banks to create credit.
* When banks grants a loan to customer, it does not make payment in cash. Instead the bank opens an account in the name of the customer. Such deposits are known as derivative deposits and arise from grating of loan by the bank.
* The customer is authorized to withdraw money from this account by issuing cheques as and when required. It is because of this system that we have the banking maxim: “Every loan creates a deposit.”
* Now the customer with derivative deposit may issue cheques out of this deposit to make payments arising out of business transactions. The payees in these transactions may deposit these cheques with another bank.
* Now this another bank accepts these cheques as primary deposits on the basis of which it will create derivative deposits. In this way the total volume of credit created by all the banks are a multiple of the initial amount created by the initial bank.
* Let us illustrate the process with the help of an example. Suppose the CRR

**Meaning of NPA:**

"The interest or the installment, which has not been paid since last two quarterly periods on all types of advances and loans, is called NPA of the financial Institution".

Term loan, cash credit, over draft and bill purchasing - all these are included in loans and advances, when loans and advances are not recovered timely, they are known as 'NPA'. NPA is also called 'Inefficient Assets' of nationalized banks.

Reason & Recommendations/Suggestions for NPA:

Here follows the detailed study of reasons and recommendations of/for NPA:

**Reason - Sick Industrial Units:**

Sometimes, the owners of the business unit pay installment and interest regularly to the bank for some particular period. But, as the time passes, sometimes it becomes difficult and financial administration cannot be done and payment of installment and interest becomes difficult. With the passage of time, such a unit is declared as 'sick unit'. The bank is forced to take an account of such a business unit into NPA.

**Recommendation/suggestion:**

The bank must watch the progress/condition of business constantly. As soon as something is heard about 'sickness' of the unit, immediate steps/action should be taken for recovery of such account.

**Reason - Defective Valuation/faulty Appraisal of the project:**

Sometimes, it happens that the business unit applies for loans and advances; it has to present the project report. The valuation/appreciation, done by the banking officer is, sometimes, defective and over finance, than the real capacity, is provided to the business unit. Naturally, the unit becomes incapable of repayment and thus, the account becomes NPA.

**Recommendation/suggestion:**

It can be suggest here that appreciation/appraisal/valuation of business report must be carried out properly. In fact, this is the root from where NPA may be prevention is always better than cure.

**Reason – Incomplete Document:**

Very often the documents provided by the business unit are not sufficient. The Bank officer let them go and remain flexible / adjustable for one or another reason. When the time for installment and interest comes, the account holder may escape from the responsibility due to insufficient documents. Finally, the bank has to fetch such an account to NPA.

**Recommendation/suggestion:**

The bank officer should not remain flexible as far as requirement of document is concerned. This will prevent increase in NPA.

**Reason - Political Influence:**

It happens that improper persons/business units may bring political pressure upon the banks for loans and advances. Naturally, such loans and advances are used for the purpose other than business. When the time comes for installment and interest, such improper persons/business units intentionally become bankrupt in the market and their accounts become NPA.

**Recommendation/suggestion:**

It can be suggested here that political influence should not be given priority and the bank officers should be empowered to reject such application and pressure. Moreover, politicians should behave responsibly and reasonably.

**Reason - Acceptance of weak securities:**

It is natural that loans and advances are provided against securities, but it is experienced that some banks and their officers become very generous at the time of valuation of security and grant of loans and advances. When the account holder does not pay interest and installment, his securities are not found enough to cover his loans and advances and thus, the issue of NPA arises.

**Recommendation/suggestion:**

The bank officer should accept only concrete securities which are having the highest range of liquidity.

**Reason - Acceptance of weak securities:**

It is our general experience that our laws proved to be very weak and humble, when implementation is required. Not only that the court proceeding goes on for couple of years. As we know, our total system is as good as corrupted and there are loopholes in our laws. All these generate the problem of NPA.

**Recommendation/suggestion:**

The loop holes of the law must be filled up concretely. Strict actions/steps must be taken against violation or corrupt people. Really, something should be done to set 'fear of law' in the heart of law breakers.

**Reason - Inadequate efforts for recovery:**

It is natural that the installment and interest both are paid regularly in the beginning, but there after irregularity enters because of many reasons. The bank officers themselves are not much alert for such account in initial stage and ultimately such an account become NPA.

**Recommendation/suggestion:**

The bank officer should remain alert about such account holders and such suspected accounts must be monitored at a suitable interval of time. The officer must take actions before it is too late.

**Reason - Facility of subsidy/compensation relief in recovery:**

A facility of relief of granted in agricultural finance in 1990. Thereafter, farmers and account holders are tempted to wait for the declaration of relief in loans and advances. Thus, the account holder affords/ is able to pay interest and installment, they do not do so and they postpone or withheld the payment. This is one kind of intentional bankruptcy under the name of compensation or relief.

**Recommendation/suggestion:**

The government should abolish any kind of unnecessary concession/relief/subsidy. It should be made very much clear to the account holder that interest and installment must be paid regularly.

**Reason – Lake of Trained staff for recovery of NPA:**

In fact, the concept of NPA has come into limelight comparatively in the recent years, yet the issue of NPA is an age-old banking sector just recently. The banking officers are not trained sufficiently for the recovery of accounts likely to be NPA. Many a time, the banking officers do not know the process to be followed, when account becomes NPA. Such a way, seasoned account holders may take disadvantages of bank officers.

**Recommendation/suggestion:**

To overcome this barrier, the banking officers must be trained with seminars etc. they should be provided with the knowledge of, firstly, the banking process and then, court proceedings for such recoveries.

**Reason - Non-computerized banking system/difficulty in core banking:**

The computer has entered the banking sector, but its scope is limited to metros and some big cities only. The bank and their branches at rural level and some urban level are not equipped with computerization. In absence of computers, it really becomes difficult to trace the accounts, which are on the verge of NPA.

**Recommendation/suggestion:**

It can be suggested that computerization should be adopted equally at all levels, and it should be used to trace the accounts likely to be NPA.

**Reason - Corrupted bank officer/banking system:**

Corruption is wide spread in our country. Banking sector is not an exemption. The corrupted bank officers provide loans and advances to improper persons and business units. Not only officers and managers, but also general managers/chairmen of national bank are involved in the scams of loans and advances for crores of rupees. When such a thing happens, there is no way out.

**Recommendation/suggestion:**

In fact, corruption has become a global issue, so there is little hope for it in our country. Nevertheless, when such officers are identified, they must be punished so strictly that others may get a lesson from it.

**Reason - Natural factors:**

Sometimes, natural factors play a major role and account holder becomes unable to pay installment and interest. Draught excess rain, cyclones, earth quack etc. are natural factors/ elements. At such a time, some accounts may be NPA.

Here, it is remarkable that the bank itself provides relief, aid, compensation or subsidy to account holder in above circumstances.

**Recommendation/suggestion:**

Sometimes, it happens that account holder may fetch undue benefit from the natural factors. The bank should remain alert that only real victims should be granted relief and compensation.

**Central Bank**

A Central Bank is the highest financial institution in the country. It is the leader of banking system and highest monetary authority of the country. Central bank of India is The Reserve Bank Of India. It was set up on 1 April 1935 as private shareholders bank. It was nationalized on 1 January 1949. Since then RBI is performing various functions of a Central Bank.

**Functions or Role of Central Bank.**

A Central Bank of any country performs certain significant functions for public welfare. M.H.De.Cock in his book on “Central Banking” has highlighted the following functions of the Central Bank. They are as follows.

* **Bank of Issue:**

A Central Bank is the bank of issue in the country. It enjoys monopoly of note issue in the country. It enjoys monopoly of note issue. In India RBI as monopoly power to issue currency. When this power is given only to central bank there will be two advantages.

1. There will be homogeneity in note issue.
2. There will be elasticity in amount of money.

* **Banker To Government:**

A central bank is banker to government. As a banker to government,a central bank keeps deposits of different government bodies and transfers money from one account to other account as per the instructions of the government. Further, a central bank as a banker to the government provides loans to government whenever latter demands. A central bank is also a advisor and agent to government. As advisor to government it provides important advices to government with regards to formation of economic policies. As agent to government central bank will buy or sell government securities in the market.

* **Banker to Banks:**

A Central Bank is the banker to banks in the country. As a banker to the banks central banks performs the following functions:

1. It accepts deposits of money from various banks of the country. All banks in the country are supposed to keep deposits with the central bank.
2. A central bank acts as a center of clearing house. Interbank indebtedness is settled through the central bank.
3. A central bank is the lender of last resort to the banks in need.

* **Controller of credit:**

A central bank acts as a controller of credit created by commercial banks. Central bank may use various types of quantitative and qualitative methods to control the credit created by commercial banks.

* **Custodian of foreign exchange reserves:**

A central bank is custodian of foreign exchange reserves. All foreign currency earned by a country is under the custody of central bank of the country. This is important to ensure that there will not be misuse of foreign exchange. Any individual or organization will have to take the permission of central bank for the use of foreign exchange.

* **Collection and publication of data:**

A central bank collect data related to various issues in the economy. Such information’s are published by the central bank in journals, bulletins etc. They may be of great importance for scholars of economics and government of the country. A central bank can also appoint committee of experts to find out causes and solutions of any economic problem that country is facing. The government could accept this.

* **Promotional function:**

A central bank is responsible to promote economic development of the country. It has to create suitable atmosphere for economic development of the country. Central bank must develop a sound banking system and proper money market so that loans will be available for developmental activities. It will encourage economic development of the economy.

**INSTRUMENTS OF RBI to Control Credit**

A central bank can use various methods to control credit created by a commercial bank. Central bank uses two sets of method namely:

**Quantitative methods.**

The various quantitative methods used by a central bank control the volume of credit.

**Bank rate policy.**

This is one of the important quantitative methods used by central bank in every country. Bank rate refers to the rate of discounting or more appropriately, rate of re discounting the bills of exchange by the central bank brought to it by the commercial banks. If a central bank wants to reduce the amount of credit it will increase the bank rate and if it wants the expansion of credit it will reduce the bank rate. When the bank rate is increased by central bank borrowing from the central bank becomes dearer to commercial banks. Hence, either they will stop borrowings from central bank and create small credit or they will increase their lending rate so that demand for loan decreases.

Similarly, when central bank wants expansion of credit bank rate will be reduced. So that commercial bank will borrow in large quantity and they will create large amount of credit. When bank rate is, higher it is known as dear money policy and when bank rate is lower, it is known as cheap money policy.

**Open Market Operation**

It refers to purchase or sale of government securities in the market by the central bank. When a central bank wants to reduce the volume of credit it will offer for sale of government securities. Such securities are purchased by commercial banks with result availability of cash with commercial banks will decrease and they will be able to create a small amount of credit. In opposite case when central bank wants expansion of credit, it will purchase securities. Thus commercial banks will sell their security holdings and receive cash from central banks. As a result amount of cash with commercial bank will increase and they will be able to create large amount of credit. But main limitation of open market operations are it requires as well developed market in government securities.

**'Reverse Repo Rate'**

Reverse repo rate is the rate at which the central bank of a country (Reserve Bank of India in case of India) borrows money from commercial banks within the country. It is a monetary policy instrument, which can be used to control the money supply in the country. Description: An increase in the reverse repo rate will decrease the money supply and vice-versa, other things remaining constant. An increase in reverse repo rate means that commercial banks will get more incentives to park their funds with the RBI, thereby decreasing the supply of money in the market.

**'Repo Rate'**

Repo rate is the rate at which the central bank of a country (Reserve Bank of India in case of India) lends money to commercial banks in the event of any shortfall of funds. Monetary authorities to control inflation use repo rate. Description: In the event of inflation, central banks increase repo rate as this acts as a disincentive for banks to borrow from the central bank. This ultimately reduces the money supply in the economy and thus helps in arresting inflation. The central bank takes the contrary position in the event of a fall in inflationary pressures. Repo and reverse repo rates form a part of the liquidity adjustment facility.

**'Statutory Liquidity Ratio'**

The ratio of liquid assets to Net Demand and Time Liabilities (NDTL) is called statutory liquidity ratio (SLR). Description: Apart from Cash Reserve Ratio (CRR), banks have to maintain a stipulated proportion of their net demand and time liabilities in the form of liquid assets like cash, gold and unencumbered securities. Treasury bills, dated securities issued under market borrowing programmed and market stabilization schemes (MSS), etc. Also, form part of the SLR. Banks have to report to the RBI every alternate Friday their SLR maintenance, and pay penalties for failing to maintain SLR as mandated.

**Variations in CRR**

CRR refers to a certain proportion of total deposits received by a bank, which is to be maintained in the form of reserve cash. CRR is fixed by central bank of the country. When central bank wants to reduce volume of credit, it will increase CRR so that commercial banks will be able to create a small amount of credit. In opposite case it will reduce CRR so that banks will be able to create large amount of credit.

CRR is also having various limitations. When there are huge sum of deposits with commercial banks, they will be able to create large amount of credit and maintain CRR as well.

**Qualitative methods**

Such methods are used to keep a check on use of credit. Various selective tools used by central bank in different countries are as follows:

**Margin requirements**

Margins refers to the difference between the value of security and the amount of loans sanctioned against the securities. When central banks want to create more credit for a particular purpose it will reduce margin requirement and when it wants to reduce the credit for other purpose it will increase marginal requirement.

**Regulation of consumer credit**

When a central bank wants to reduce the credit for the purchase of consumer goods, it will regulate terms and conditions of consumer’s credit. Central bank can increase the amount of down payment and reduce the period of repayment for consumer loans. This will discourage demand for consumer goods.

**Issue of directives**

A central bank can issue directives to commercial banks to follow a certain credit policy. Directives may be issued by central bank in the form of notices or circulars sent to commercial banks. Since central bank enjoys considerable power and authority commercial banks will care for its directives.

**Moral suasion and publicity.**

Under moral suasion, central bank invites commercial banks for an open-heart discussion and central bank persuades commercial banks to follow a credit policy in the interest of the country. Under publicity, central bank will use print media and electronic media to persuade banks and people to follow the credit policy of central bank.

**Direct action**

When central banks finds that none of the above methods are effective it goes for direct action against those individual banks that do not follow the credit policy of the central bank. Direct action may be taken in following forms

* Central will charge a higher rate of interest on loans given to those banks that do not follow the credit policy of the central bank.
* Central bank may refuse to give any loan to a bank that does not follow credit policy of the central bank.

**UNIT: 3**

**KEYNESIAN THEORY-1**

Lord John Maynard Keynes has been one of the most renowned economists of the 20th century. His outstanding publication “the general theory of employment” has brought far changes in the economic theory.

Keynes theory of income and employment is based on two fundamental assumption

* Total money income of the people (Y) is equal to the money value of the total output they produce during a year. (PX).

IN short, Y=PX

P= PRICE LEVEL

X= OUTPUT

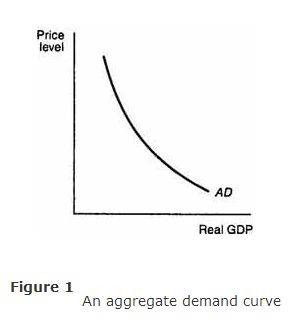
* Total output depends on level of employment of labor only .Total output increase with the increase in employment and vice versa
* It should now be clear why Keynes theory is called theory of income and employement . this is so because in Keynes theory , income and employment move together in same direction in same proportion
* Moreover , Keynes theory is also known as general theory of employment because it deals with economic system like income, employment, savings , investment etc

**KEYNES’ THEORY OF EMPLOYMENT (THEORY OF EFFECTIVE DEMAND)**

Just as equilibrium price of a commodity is determined by the interaction between its demand and supply in a free market, similarly the equilibrium level of employment and output in the whole economy is determined by the interaction between aggregate demand price and aggregate supply price.

* **Aggregate Demand Price Curve :**

Aggregate demand price refers to the total sale proceeds which the producers expect to receive from the sale of output at a particular level of employment. in this sense, aggregate demand price depends on the money expenditure of the people on goods and services. Since money income of the people increases with the level of output and employment money expenditure of the people also increases with the level of output and employment in the economy. This means that aggregate demand price will increase with output and employment.

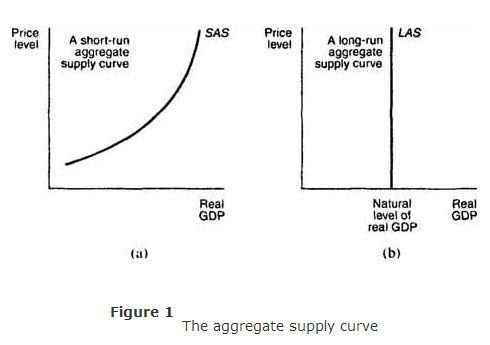


* **Aggregate supply price curve** :

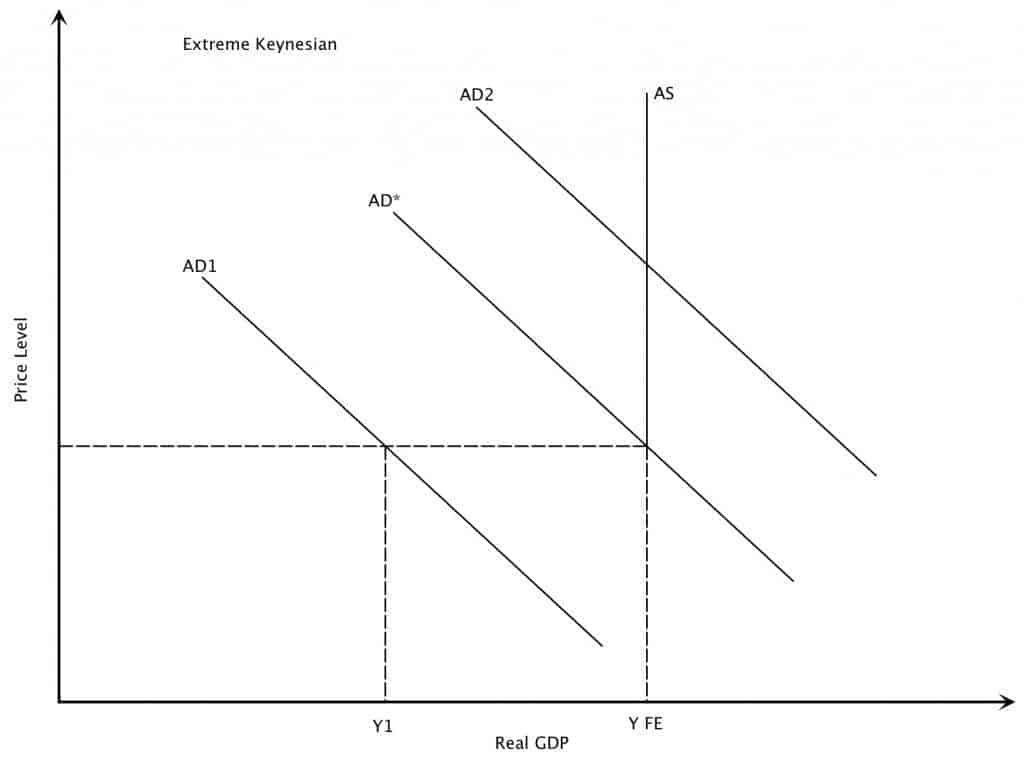
Aggregate supply price refers to total sale proceeds which the producers must receive from sale of output at particular level of employment so that cost of output is fully recovered

Generally total cost increase with the increase in output and employment .therefore aggregate supply price increase with increase in output and employment.

This is why aggregate supply price curve showing relationship between aggregate supply price and employment is upward sloping.



**EQUILIBRIUM LEVEL OF OUTPUT AND EMPLOYMENT :**

As said before equilibrium level of output and employment is given by the point of intersection between aggregate demand price curve and aggregate supply price curve.

**DETERMINANTS / COMPONENTS OF AGGREGATE DEMAND :**

Keynes has classified aggregate demand in to two groups. Consumption and investment .consumption refers to total demand for consumption goods or total money expenditure of the people on consumption goods.

Investment refers to total demand for capital goods

In terms of equation :

**D=C+I**

Where, D= aggregate demand

C= consumption exp.

I= investment expenditure

If there is an increase in consumption exp Or investment , aggregate demand will increase and will increase output and employment also .

There are two determinants of consumption expenditure, income and propensity to consume of the people . If people’s propensity to consume is constant , consumption expenditure is increase with income .If income is constant then expenditure increase with the increase in propensity to consume Investment exp also depends on two variables marginal efficiency of capital and rate of interest. The rate of interest is determined by total supply of money and total demand for money in the economy.

Although income is the main determinant of consumption function, there are other determinants also which influence consumption function. If other factors are constant the effect of change in income on consumption is expressed by the movement on the same consumption curve. If income is constant, the effects of change in other factors on consumption expressed by shifting the whole consumption curve up or down these other determinants can be put under two heads as follows

**SUBJECTIVE DETERMINANTS**

* Individual motive
* Business motives

**OBJECTIVE DETERMINANTS**

* **Fiscal Policy**

Fiscal policy relates to government taxing and spending policy. Progressive taxation adopted by modern welfare states to reduce inequality of income tend to shift consumption upwards by transferring purchasing power from the rich to the poor. Controls, rationing and such other restrictions on spending imposed during war-time or during the period of planned development depress overall consumption in the economy.

* **Windfall Gains or Losses :**

Windfall gains consequent -upon stock market fluctuations or any other factor will stimulate consumption. The opposite effect will follow in case of windfall losses. Unexpected increase in incomes shifts consumption upwards while unexpected cut in incomes shifts it downwards.

* **Changes in Expectations :**

If people expect prices to rise in future, there will be a heavy rush for buying in the present, shifting consumption upwards. Expectation of decline in prices in future will depress consumption. Similarly, when people expect income to increase. they may save less and consume more out of current income. Thus, expectations about future income also affect their consumption.

* **Changes in the Rate of Interest :**

Changes in the rate of interest influence consumption through their effects on the market values of securities. A fall in the rate of interest, by raising the market prices of securities is likely to increase consumption. A rise in the rate of interest may shift consumption downwards by reducing the market prices of securities. However, substantial changes in the rate of interest are not likely to occur in the short period. Therefore, this objective factor may be regarded as only of secondary importance in the short run.

* **Changes in Wage Rate :**

If wage rate is increased, there will be an increase in consumption expenditure, because workers have a high propensity to consume. In other words, when wage rate is increased consumption curve shifts up. However, if the rise in wage rate is followed b); a more than proportionate increase in prices, the real wage rate will fall and consumption curve will shift in the downward direction.

**Unit 4 KEYNESIAN THEORY -2**

**CONCEPT OF INVESTMENT**

Investment in the theory of income and employment means real investment, which is different from financial investment. By real investment, we mean addition to the nation’s physical stock of capital like the building of new factories and new machines as well as the addition to the stock of finished and unfinished goods called inventories or investment.

Thus, investment in the present context does not mean purchase of existing shares and debentures and real property.

Keynesian theory of income and employment is concerned with private investment not with public investment. Private means investments by firms and business. While public investment means by state and central government.

**DETERMINANTS / FUNCTION OF INVESTMENT:**

We have noted that total demand is made up of two components i.e demand for consumer goods and demand for capital goods .Investment function relates the demand for the latter i.e. capital goods. The demand for capital goods depends upon marginal efficiency of capital and rate of interest. Investment activity in any economy is determined by

* Expected rate of profit on capital and the rate of interest

**FACTORS AFFECTING MARGINAL EFFICIENCY OF CAPITAL**

* **EXPECTATIONS :**

MEC is more volatile than rate of interest. This is because prospective yields of capital assets depends upon business expectations

* **STOCK OF CAPITAL GOODS:**

The MEC and capital stock are inversely related .if the existing stock of capital goods is large. MEC will be low

* INVENTIONS AND INNOVATION
* NEW PRODUCTS
* POPULATION GROWTH
* STATE POLICY
* POLITICAL CLIMATE
* CHANGE IN INCOME
* PROPENSITY TO CONSUME
* LIQUID ASSETS

**CONCEPT OF MULTIPLIER**

Keynes’ concept of investment multiplier is based on R.F.KAHN’S concept of employment multiplier.

Keynes investment multiplier on the other hand refers to the change in equilibrium level of income consequent upon a given chance in autonomous investment spending.

Keynes investment multiplier is defined as co-efficient relating additional investment and additional income .

To be more simple, investment multiplier is the ratio of change in income to change in investment and is mathematically represented as follows

K equals to delta Y upon DELTA I

**Assumption of multipler.**

1) Change in autonomous investment

2) Marginal propensity to consume is constant

3) Net increase in investment

4) Economy is industrialized

5) Foreign trade is closed

6) Increase in income

**Leakages of multiplier.**

1) Saving

2) Uneven distribution profit

3) Taxation

4) Imports

5) Payment of old debts

6) Hoarding of cash

7) Inflation

**Significance of multiplier**

1) Importance of investments

2) Saving-investment equality

3) Trade cycle

4) Control of trade cycle

5) Deficit financing