LESSON-1

MONEY: MEANING, FUNCTIONS AND CLASSIFICATION

STRUCTURE

1.0 OBJECTIVE

The objective of the chapter is specially focused on money as well as its various functions, classification and methods of currency note issue in India.

1. To know about the various measurement of money because modern society cannot run without it. We cannot think of a society today which can do away with money.
2. To study the various types of money that has changed its form with time keeping in tune with the different stages of development of the society.
3. To learn and go through the several functions of money and its important lies in the fact that act as medium of exchange, as a unit of account, as a standard of deferred payments and as a store of value.

4. To study the pivotal innumerable benefits of money in our day –to- day lives which play vital role to upliftment of the society.

1.1 INTRODUCTION

The use of barter-like methods may date back to at least 100,000 years ago, though there is no evidence of a society or economy that relied primarily on barter. Instead, non-monetary societies operated largely along the principles of gift economics and debt. When barter did in fact occur, it was usually between either complete strangers or potential enemies.

Many cultures around the world eventually developed the use of commodity as money. The shekel was originally a unit of weight, and referred to a specific weight of barley, which was used as currency. The first usage of the term came from Mesopotamia circa 3000 BC. Societies in the Americas, Asia, Africa and Australia used shell money – often, the shells of the money cowry (Cypraea Moneta L. or C. annulus L.). According to Herodotus, the Lydians were the first people to introduce the use of gold and silver coins. It is thought by modern scholars that these first stamped coins were minted around 650–600 BC.

The system of commodity money eventually evolved into a system of representative money. This occurred because gold and silver merchants or banks would issue receipts to their depositors – redeemable for the commodity money deposited. Eventually, these receipts became generally accepted as a means of payment and were used as money. Paper money or banknotes were first used in China during the Song Dynasty. These banknotes, known as "jiaozi", evolved from promissory notes that had been used since the 7th century. However, they did not displace commodity money, and were used alongside coins. In the 13th century, paper money became known in Europe through the accounts of travelers, such as Marco Polo and William of Rubruck. Marco Polo's account of paper money during the Yuan Dynasty is the subject of a chapter of his book, The Travels of Marco Polo, titled "How the Great Kaan Causeth the Bark of Trees, Made Into Something Like Paper, to Pass for Money All Over his Country".http://en.wikipedia.org/wiki/Money - cite_note-Marco_Polo-17 Banknotes were first issued in Europe by Stock holms Banco in 1661, and were again also used alongside coins. The gold standard, a monetary system where the medium of exchange are paper notes that are convertible into pre-set, fixed quantities of gold, replaced the use of gold coins as currency in the 17th-19th centuries in Europe. These gold standard notes were made legal tender, and redemption into gold coins was discouraged. By the beginning of the 20th century almost all countries had adopted the gold standard, backing their legal tender notes with fixed amounts of gold.

After World War II, at the Bretton Woods Conference, most countries adopted fiat currencies that were fixed to the US dollar. The US dollar was in turn fixed to gold. In 1971 the US government suspended the convertibility of the US dollar to gold. After this many countries de-pegged their currencies from the US dollar and most of the world's currencies became un backed by anything except the governments' fiat of legal tender and the ability to convert the money into goods via payment.

Etymology

The word "money" is believed to originate from a temple of Hera, located on Capitoline, one of Rome's seven hills. In the ancient world Hera was often associated with money. The temple of Juno Moneta at Rome was the place where the mint of Ancient Rome was located. The name "Juno" may derive from the Etruscan goddess Uni (which means "the one", "unique", "unit", "union", "united") and "Moneta" either from the Latin word "monere" (remind, warn, or instruct) or the Greek word "moneres" (alone, unique). In the Western world, a prevalent term for coin-money has been *specie*, stemming from Latin *in specie*, meaning 'in kind'.

Barter System

During the primitive stages of civilization, human needs were simple and every person produced all that was needed to sustain life - he gathered his own food, sewed his own clothes and built his own shelter. Robinson Crusoe collected his own food, wore fig leafs and lived in caves. He fulfilled all his requirements and exchanged nothing because it was a one man economy. Though, earlier societies were not one man society, they fulfilled all their requirements on their own. In course of time, people started different occupations and with specialization in production of some goods and services, trade among people came into existence. In the beginning, trade was direct. It involved exchange of goods for goods. For example, exchange of rice for shoes by some individuals. This exchange of goods for goods was known as barter. In this system of exchange, there were several difficulties and inconveniences.

Difficulties of Barter System

Barter system had certain difficulties which created numerous inconveniences to people. They are:

- The most obvious inconvenience of barter system was the requirement for a double coincidence of wants. A man, who wanted to exchange some rice for cloth, had to find another person who not only wanted that same good i.e., rice, but had cloth to offer in exchange.

- The quantity of goods which the two parties wanted to exchange should be equal in value to each other. One cannot exchange one cow for 10 kg of rice. The value of a cow and 10 kg of rice are different.

- Those who enter in barter trade should know how to calculate the value of commodities exchanged. For instance, a shoemaker and a farmer wanted to exchange shoe against rice.

They should first come to a decision in what ratio the two goods should be exchanged. Difficulties were experienced in this exchange as there were no agreed prices. There was no common measuring unit in terms of which value of goods could be expressed. The price of goods or exchange ratio was determined by the intensity of each other's demand.

- In barter system, exchange would not be possible if the possessions or property of a person could not be divided or sub-divided without loss. For example, if an individual's wealth consisted of cow, it would be almost impossible for him to barter them for value of small article.

- The exchange of services would be far more complicated than the trading of goods. For example, how to pay for the services rendered by a teacher or a barber is not easy to decide in a barter system.

- In a barter system, it is very difficult to accumulate wealth for future use. Most of the commodities like, corn, cattle, wheat, etc., lack adequate durability and deteriorate over time and therefore cannot be stored conveniently for long duration for future use.

Thus, the difficulties associated with this barter system compelled human beings to give up this sort of exchange and to look for something easily recognizable and generally acceptable to all. This commonly accepted commodity or thing had to act as a medium of exchange. This medium of exchange formed the basis for earlier definition of money.

Money may be anything chosen by common approval as a medium of exchange. The chosen thing or commodity should be commonly accepted in payment for goods and services and to clear debts. Money is given and received without reference to the standing of the individual who offers it in payments for goods and services. Money is defined by its use in exchange or commerce. This gives the widespread notion of money as a 'medium of exchange' or 'means of payments'. Some economists defined money in terms of its general- acceptability. D. H. Robertson defines money as, "Anything which is widely accepted in payment for goods or in discharge of other kinds of business obligations". In the opinion of Walker, "Money is what money does." Seligman defines it as, "One thing that possesses general acceptability." These definitions are too narrow and put light one or two aspects of money. Crowther termed it as, "Anything that is generally acceptable as a means of exchange and at the same time acts as a measure and store of value." Some definitions provided by economists makes it clear that the definition of money is fundamentally functional and also must satisfy the general acceptability criterion. In this context, the definition provided by Crowther may be considered superior.

- Money was once recognized with coins. This remains the first definition of money given by the Oxford English Dictionary: 'coin: metal stamped in pieces of portable form as a medium of exchange and measure of value'. The recognition of 'money' with 'coin' reinforces the idea of the physical presence of money whereas the idea of 'commodity money' implies that 'money' is abstract and that any asset might potentially serve as money. The abstract character of money is preserved in the function of money as a 'unit of account'. That is, the use of money allows the value of different goods and services to be expressed in a common unit or numeraire. The definition of money does go on from coins and allows the possibility that money consists of 'any currency'. Currency, in turn is defined as anything that circulates from person to person in the process of exchange and so we have the possibility that money might take a variety of forms. Nevertheless, for most people the word 'currency' indicates notes and coins or cash or what might be called 'ready money' in everyday use. And yet, the underlying idea remains that money is anything that is acceptable in payment for goods and services.

1.2 DEFINITION AND MEANING

Money is any object or record that is generally accepted as payment for goods and services and repayment of debts in a given socio-economic context or country. The main functions of money are distinguished as: a medium of exchange; a unit of account; a store of value; and, occasionally in the past, a standard of deferred payment. Any kind of object or secure verifiable record that fulfills these functions can be considered money.

Money is historically an emergent market phenomenon establishing commodity money, but nearly all contemporary money systems are based on fiat money. Fiat money, like any check or note of debt, is without intrinsic value as a physical commodity. It derives its value by being declared by a government to be legal tender; that is, it must be accepted as a form of payment within the boundaries of the country, for "all debts, public and private". Such laws in practice cause fiat money to acquire the value of any of the goods and services that it may be traded for within the nation that issues it.

The money supply of a country consists of currency (banknotes and coins) and bank money (the balance held in checking accounts and savings accounts). Bank money, which consists only of records (mostly computerized in modern banking), forms by far the largest part of the money supply in developed nations.

1.3 FUNCTIONS OF MONEY

In the past, money was generally considered to have the following four main functions, which are summed up in a rhyme found in older economics textbooks: "Money is a matter of functions four, a medium, a measure, a standard, a store." That is, money functions as a medium of exchange, a unit of account, a standard of deferred payment, and a store of value. However, modern textbooks now list only three functions, that of medium of exchange, unit of account, and store of value, not considering a standard of deferred payment as a distinguished function, but rather subsuming it in the others.

There have been many historical disputes regarding the combination of money's functions, some arguing that they need more separation and that a single unit is insufficient to deal with them all. One of these arguments is that the role of money as an exchange in conflict with its role as a store of value: its role as a store of value requires holding it without spending, whereas its role as a medium of exchange requires it to circulate. Others argue that storing of value is just deferral of the exchange, but does not diminish the fact that money is a medium of exchange that can be transported both across space and time. http://en.wikipedia.org/wiki/Money - cite_note-22 The term 'financial capital' is a more general and inclusive term for all liquid instruments, whether or not they are a uniformly recognized tender.

1. **Medium of exchange**

   When money is used to intermediate the exchange of goods and services, it is performing a function as a medium of exchange. It thereby avoids the inefficiencies of a barter system, such as the 'double coincidence of wants' problem.

2. **Unit of account**

   A unit of account is a standard numerical unit of measurement of the market value of goods, services, and other transactions. Also known as a "measure" or "standard" of relative worth and deferred payment, a unit of account is a necessary prerequisite for the formulation of commercial agreements that involve debt. To function as a 'unit of account', whatever is being used as money must be:

- Divisible into smaller units without loss of value; precious metals can be coined from bars, or melted down into bars again.
- Fungible: that is, one unit or piece must be perceived as equivalent to any other, which is why diamonds, works of art or real estate are not suitable as money.
- A specific weight, or measure, or size to be verifiably countable. For instance, coins are often milled with a reeded edge, so that any removal of material from the coin (lowering its commodity value) will be easy to detect.

3. Store of value

To act as a store of value, money must be able to be reliably saved, stored, and retrieved – and be predictably usable as a medium of exchange when it is retrieved. The value of the money must also remain stable over time. Some have argued that inflation, by reducing the value of money, diminishes the ability of the money to function as a store of value.

4. Standard of deferred payment

While standard of deferred payment is distinguished by some texts, particularly older ones, other texts subsume this under other functions. A "standard of deferred payment" is an accepted way to settle a debt – a unit in which debts are denominated, and the status of money as legal tender, in those jurisdictions which have this concept, states that it may function for the discharge of debts. When debts are denominated in money, the real value of debts may change due to inflation and deflation, and for sovereign and international debts via debasement and devaluation.

5. **Measure of value**

Money acts as a standard measure and common denomination of trade. It is thus a basis for quoting and bargaining of prices. It is necessary for developing efficient accounting systems. But its most important usage is as a method for comparing the values of dissimilar objects.

1.4 CLASSIFICATION OF MONEY

Along with the development of human civilization, money also changed its form and its role to meet new challenges for economic prosperity and development of society. Money evolved itself over the ages starting from animal money to credit cards of today. Economists have identified the following phases in the evolution of money:

- Animal Money
- Commodity Money
- Metallic Money
- Convertible Paper Money
- Fiat Money
- Bank Money
- Super Money
- Electronic Money

- **Animal Money**

In primitive hunting era, animals were used as a common medium of exchange. Historical evidence shows that cattle occupied a very holy and honorable place in the society. In the continents of Asia, Africa and Europe, cattle were considered as the standard unit for barter purpose. In ancient Indian civilization, 'Godhan' (cattle wealth) as a form of money is referred in Artharva Veda as sacred. Animals like goat and sheep were also considered as sacred. Animal money is quoted as the best example. In the early 1400s, Malacca was a busy port handling many ships from East Asia and the Western world. Malacca was the "halfway house" where traders from the East would come in, replenish and trade with their counterpart traders from the West. The history of this tin animal money started in the magnificent days of the Malacca Empire. For trading purposes some form of money had to be used at the ports. Tin was considered as a precious metal and the Chinese believed that the tin would bring fortune, wealth and destroy evil spirits. Tin, as medium of exchange was preferred to animal money. This gave birth to the Tin Animal Money. This form of money prepared by Chinese can be valued in a few denominations, where 'Kati' was used as unit of measurement. 'The largest was, weighing 1 Kati and the smallest 1/20 Kati. The full denominations are 1 Kati, 1/2 Kati, 1/10 Kati and 1/20 Kati. The rarest of them are 'the 1 and 1/2 Kati. Four distinct 'animals namely Tortoise, Fish, Rooster (Chicken) and Crab were used. Only the Tortoise comes in 1 and 1/2 Kati. The others do not have the larger denomination. It was found that each animal comes in several designs and variants. So, trade was carried out using this form of medium of exchange. It must have been a profound task for the rich to carry around 20 Katis of tin if he wanted to purchase something large.

- **Commodity Money**

The most primitive forms of money arose unexpectedly, when knowledgeable traders acknowledged certain commodities as commonly desirable for real use in the society. They could be used as the payment in any trade. Commodities such as salt, tobacco, cattle and other and other livestock, furs and other animal hides, grain, gourds, beads, seashells and feathers, were used as generally accepted medium of exchange. Historical monetary systems have flourished on the basis of commodity money. Commodity money suffered from the limitations like lack of uniformity, inadequate store of value, lack of proper transferability and indivisibility.

However, demand for such commodities depends' on the existence of following set of physical properties. These are:

- Durability
- Portability
- Easy storage
- Standardization of quality
- Easy divisibility

- **Metallic Money**

Metallic money refers to coins prepared out of various metals like Gold, Silver, Bronze, Nickel etc. The standard configuration of the coin should be of given size, shape, weight and fitness. Its value is certified by an exclusive monopoly of the state. The right of minting the coins vests with the department concerned of the government of a country.

Coins can be mainly of two types:

- Standard coin refers to a coin whose face value or exchange value is equal to its intrinsic value. In earlier days, precious metals like gold and silver were regarded as standard coins and monetary system often referred to them as gold and silver standards.

- Token coin refers to a coin' whose face value of exchange value is more than it's intrinsic value Token coin are usually prepared using cheap metals like Nickel, Copper and Bronze.

The use of the above metals' facilitated the establishment of coin system in the economy. The right to issue these coins vests with the state, authorities, either the treasury or central bank of the country. Therefore, the money issued by them is considered as the legal tender. Standard coins have extensive legal tender and can be transacted only for small amounts. Token coins have limited legal tender and can be transacted only for small amounts. One major limitation of metallic money is that rapid transactions are difficult and therefore, not feasible. In addition to this, the face value of the coins may be less than the real value of the coins.

- **Convertible Paper Money**

The next most important form of money was convertible paper money. It was first used in China and later spread to medieval Europe. Goldsmiths used to store large quantities of gold and silver and other precious metals in well-protected vaults and safes. Others began to hire these facilities to deposit and store their own valuable goods. The goldsmith issued a paper receipt 'convertible' into these deposits. Gradually, these receipts rather than the deposits were physically exchanged and paper money was born. Though paper money is widely used, it is not free from disadvantages. There is a chance of over issue of notes as they can be printed extensively. This leads to more supply of money which in turn results in inflation and thereby reduces the purchasing power of money. The durability of paper money is also less than metallic money.

- **Fiat Money**

In due course, one more institutional progress took place. The State assumed responsibility for the convertibility of paper and commodity money that it issued. It was referred to as fiat money and was intrinsically worthless. Therefore, fiat money comprises of simple currency (bills and coins) issued by the State as a medium of exchange, unit of account and store of value acceptable within a given jurisdiction. In countries like United States, Great Britain, Switzerland, Japan or Germany fiat money was accepted generally as a means of payment. People use the currency to pay their tax bills, because legal tender laws generally require private creditors to meet contractual debts. People are of the belief that official government money will continue to be widely acceptable in exchange for moderately predictable quantity of goods and services in the private markets in the foreseeable future. Regrettably, public confidence in fiat money is tremendously delicate. The reason lies in its political and economic stability conditions.

- **Bank Money**

The money developed in the form of credit money is referred to as bank money. With the establishment of monetary authority in the form of banks, another form of convertible money has developed, i.e., the bank money. Bank money constitutes the major part of money supply. Paper money and bank money together constitute total money supply:

- "M_1" includes only the paper currency and coinage in circulation among the public plus the total balances instantly available to depositors in privately held checking accounts ("demand deposits") in the country's commercial banks and similar depository institutions like savings and loans, credit unions, etc.

- "M_2" the next broadest measure of the money stock, adds to the total included in "M_1", the total amount of deposits in short-term savings accounts and small certificates of deposit. There are a number of broader definitions of the money stock.

    - M_1 (bills and coins) is the most liquid;

- M_2 (personal deposits) needs a cheque or credit card; and,

- M_3 (term deposits) requires formalities and a penalty charge.

It can be said with respect to liquidity that all assets - financial, physical and intellectual - can be converted to other things with greater or lesser degrees of liquidity.

- **Super Money**

In post-modern economy, another form of money gaining momentum is "Super money". Super money is based on the changing market value of stocks in the equity stock market. At a given point of time, market valuation of the stock can be used as 'collateral' for a bank. It can also be used as loan or line of credit in the form of fiat or deposit money. It is argued that credit cards represent a form of money, in that the deferred payment, usually 30 days is accepted in exchange until the payment is made. The whole area of 'monetary theory' is not influenced by the new forms of money that are emerging in the internet age. Liquidity is the primary characteristic of money. It refers to the time and cost involved in converting money into desired goods and services.

- **Electronic Money**

The new developments in computer and telecommunications industry opened the gates for the formation of a new form of money called the e-money (electronic money). Electronic money is defined as the digital payment message, which serves as a medium of exchange and store of value. As there is a danger of theft for paper currency and coins, electronic money evolved as a remedy. This reduces transportation costs and improves economic efficiency. A new technological improvement in the payment system is Electronic Funds Transfer System. (EFTS). According to this technology, individuals pay through either a debit card reader or a personal computer. Money becomes more easily transferable from payer to payee using electronic medium. This reduces the time consuming process of using cheques and paper money. Nowadays monetary institutions like central banks, commercial banks or corporations transfer funds to other institutions by using EFTS. For this purpose, people use plastic cards, for example, debit and credit cards (American Express, Visa etc). The e-money has different names like digital cash, digital money, cyber coins, e-cash, digital token etc. An important advantage of e-money as compared to earlier forms of money is that the cardholder makes payment to another without involving the bank by simply placing both the cards in a digital wallet. The digital wallet writes down the card balance on one card and writes up the card balance on the other by the same amount. The recent evolution of e-money is significant as it allocates value to a coded digital message, which is stored on a computer system or a card chip. The issuer guarantees a fixed reimbursement value.

1.5 PRINCIPLES AND METHODS OF NOTE ISSUE

Principles: There are two principles of note issue, one is called the Currency Principle and the other is named as Banking Principle. Both these principles are contradictory to each other.

(1) Currency Principle: - According to the currency principle, the central bank of the country should keep 100% gold for every note issued. In other words there should be full convertibility for the amount of legal tender currency; it assumes full convertibility of notes. The advocates of this principle of note issue are of the view that the currency under this system will expand or contract as it would have expanded or contracted under the metallic money. The currency principle assures maximum safety for the notes. Those who oppose this principle assert that the system no doubt gives safety to the currency but it lacks elasticity.

(2) Banking Principle: - According to this principle, there is no need to keep 100% gold or silver against notes issued. The notes issued should have a guarantee of convertibility into gold. It is sufficient to keep only a certain percentage of total paper currency in the form gold and silver reserves. The notes issued in the country should be according to the needs of trade and Industry. If at any time there is an excess of notes issued to the requirements of trade and industry, these will be returned to the bank of issue for conversion. The principle of note issue has the merit that it provides the country with an elastic currency. The guarantee of convertibility also acts as a regulator of note issue. Since it does not require 100% metallic backing against the note issue, it is therefore most economical principle. The demerit of this principle is the danger of over issue of notes, possibility of inconvertibility of excess notes, loss of public confidence in the currency and monetary instability.

Methods of Note Issue

Both the principles of note issue mentioned above, have serious defects. The monetary experts' by coordinating the advantages of both the principles have evolved various systems or methods of notes issue. The main systems of note issue prevalent in different countries of the world are

- **(1) Fixed Fiduciary System.**
- **(2) Proportional Reserve System.**
- **(3) Minimum Reserve System.**

These systems are now discussed in brief.

(1) Fixed Fiduciary System

Under this system, a fixed amount is laid down by law which needs to be covered by government securities. Notes issued in excess of this amount must be fully backed by gold. England adopted this system in 1844. The 'system lacked elasticity and was not capable of satisfying the needs of trade and industry. This system was abandoned in 1913 in favour of proportional reserve system.

(2) Proportional Reserve System

Under this system, the central bank is to keep a certain percentage of the total notes issued in gold. There is to be covered by sound government securities, trade bills etc. This system remained prevalent in USA, Great Britain and over a large part of the world. The proportional reserve system was also adopted by State Bank of Pakistan (SBP) and it remained enforced till December 1965. This system was abandoned in 1965 as it was rigid and lacked elasticity. The State Bank of Pakistan could not give guarantee for full convertibility of notes. The State Bank of Pakistan has now adopted a new system of note issue named as Minimum Reserve System.

(3) Minimum Reserve System

The proportional reserve system of note issue has been replaced by minimum reserve system in Pakistan in 1965. According to this system, the central bank is required to keep only a minimum amount of reserve in the form of gold and foreign exchange securities. The central bank can expand note issue in accordance with the volume of business activities without backing of gold. The level of currency backing by gold is fixed at Rs. 1200 million in Pakistan. The merit of this system is that it ensures an adequate supply of currency to meet the business demands of the country. In other words, the method of note issue is sufficiently elastic. The demerit is that paper currency issued is practically inconvertible in this system.

SIGNIFICANCE OF MONEY IN CAPITALIST ECONOMY

Money plays an important role in shaping the economy of any country by stimulating or even hampering economic progress irrespective of the type of economy. However, in a capitalist economy, where allocation of resources, production and distribution of national dividend are all decided by market mechanism i.e. by the forces of demand and supply. Money plays an important role in this system. It has substantial effects on output, income, employment, "consumption and economic welfare of the community at large. Economic planning which is an indispensable aspect is workable both at micro and macro level with the help of cautious financial planning. This is made possible from the following equation.

Money → Purchasing power → consumption → economic development
Money → Store of value → investment → employment → economic development.

Money through its purchasing power increases consumption and as a store of value increases investment, employment and leads to economic development.

Let us examine the following points, which highlight the dynamic role of money:

- In monetary economy, different individuals specialize in different goods. The use of money leads to discovery of two important facets namely; occupational specialization and division of labor. This resulted in widening of market over the entire world with well-organized system of exchange.

- Households and firms affect the two important economic concepts namely savings and investment. Households save and firms invest. The equality between savings and investment leads to equilibrium condition of income, output and employment. Economy takes care of transforming savings into investments. The mobilization of savings is better done with the help of monetary institutions.

- Modern monetary system helps the government to spend money on social overhead capitals, economic policies and political policies. It also helps in redistribution of income and wealth by means of taxation and expenditure.

- Compared to assets such as saving accounts, bonds government securities, treasury bills, common stock, inventories and real estate, money is the most liquid asset. It possesses two basic determinants like capital certainty and shift ability. Capital certainty of an asset entails that it can be easily converted to another form of asset without loss of value. The shift ability feature of an asset ensures a readily exchangeable feature of the commodity.

- Unlike other financial assets, money possesses 100 percent liquidity. Financial assets are termed as near-money. Time deposits and saving deposits with commercial banks and other banks, postal saving deposits, savings in Unit Trusts, bills of exchange, treasury bills, marketable government securities, saving bonds and certificates, life insurance policies, shares of investment trusts, shares of joint stock companies and transferable credit instruments constitute near money. These kinds of financial, assets are also quite liquid and can be readily converted to money by selling and discounting them without any significant loss.

DEFECTS OF MONEY

Money plays a vital role in today's economy. However, money has also certain defects. Some writers regard it as the source of all evils in society. J.S. Mill regarded as an insignificant thing in the economy. These limitations of money are:

- Money is something which is very difficult to define since it fits into the category of stuff which is not amenable to any single definition. We know one of the important functions of money is to act as the medium of exchange. If we define money as an asset that is generally acceptable in exchange of goods and services, the demand for money becomes an indirect demand. What people require are goods and services but they want money in order to carry-out the transactions. Thus, money is not demanded for its own sake and hasn't any intrinsic value of its own.

- In this ultra post-modern age, money has taken electronic form due to advancement in technological sphere. This has changed the meaning of 'exchange'. Today, the exchange of product is often based not on the transfer of money but on the promise to make payment later. That is, the buyer goes into debt, usually being granted credit by the trader, a bank or some financial intermediary. Thus, exchange occurs only when the debt incurred by the purchase is settled and for this to take place there has to be a transfer of money. But this is fundamentally different from the idea of exchange that money allows.

- Money is required to enter into an act of exchange but it is definitely not necessary. It is correct that there still exist a variety of transactions in which a purchaser must hand over to the seller bank notes or a cheque or debit card that will bring about a transfer of bank deposits. Although one cannot pay, for instance, bus fares by credit card, the array of transactions for which this is so has turned out to be much narrower in recent times. There may still be some inconvenience from not having immediate access to cash. However, the trouble of not having access to cash will be very short-term as long as one has wealth or reputation against which one can borrow. Exchange is, in general, constrained by the lack of wealth or an ability to borrow to a certain extent than by the lack of money. This understates the significance of money in exchange since it focuses on the act of exchange and gives no credence to the role of money as a unit of account.

- We know money acts as a store of value. The value of money is affected by inflation. With the rise in general level of prices, the value of money declines and vice-versa. In times of hyperinflation people refuse to accept money and prefer payment in real assets. Money turns into mere pieces of paper only in times of galloping inflation. Thus, money as a store of value has serious limitations.

- Money is believed to be responsible for creating a divide between 'haves' and 'haves not' and perpetuating this gross inequalities in the society. This led to the growing concentration of money in the hands of a few rich people. This resulted in the exploitation of poor people and the working classes and existence of misery and degradation in the society

- Money is also held responsible for corruption in the society.

Money may not produce anything; but in the absence of it, nothing can be produced in today's world. The small defects of money cannot undermine its importance in our society.

1.6 SUMMARY

- Money has a central place in our society. Money is defined as something which is generally acceptable as a medium of exchange Money performs a number of functions and its importance lies in the fact of that it acts as a medium of exchange, as a unit of account, as standard of deferred payments and as a store of value.

- In the beginning, when society was simple, trade was direct. It involved exchange of goods for goods. For example, exchange of rice for shoe by two individuals. This exchange of goods for goods was known as barter. In this system of exchange, there were several difficulties and inconveniences. It required double coincidence of wants.

- Money evolved itself over the ages and kept changing its form at different stages of its development starting from animal money to electronic money today; in sequence, the various phases of evolution of money are - animal money, commodity money, metallic money, paper money, super money and electronic money.

- Money performs different functions like - it acts as a means of payments, as a unit of account, as standard of deferred payment and as a store of value. Money is used to transact goods and services as it is generally acceptable as means of payments. Values of all goods and services can be measured in terms of money. It also serves as a store of value.

- Money, income and wealth are different and not same. Money is a stock variable and can be measured at any point of time unlike income which is a flow variable. Money is a part of wealth. Wealth is a broader concept which includes both real and financial assets in its purview.

- Money plays a dynamic role in an economy by stimulating or even hampering economic progress. It has substantial effects on output, income, employment, consumption and economic welfare of the community at large. Economic planning which is an indispensable aspect is workable both at micro and macro level with the help of cautious financial planning. This is made possible with the help of money.

- Money is the pivot around which economic activity like production, consumption, trade and commerce and government activities revolve.

- Money has certain limitations like; it cannot serve as a store of value during the times of hyperinflation. It is responsible for inequalities and corruption in society. The concept of credit card is also undermining its role as a concept of money.

1.7 KEYWORDS

Classifications, Defects, Animal Money, Commodity Money, Metallic Money, Paper Money, Super Money, Electronic Money, Medium of Exchange, Measure, Principle, Note issue, Unit of Account, Galloping Inflation, Unit Trusts, Bills of Exchange, Treasury Bills, Marketable Government Securities, Saving Bonds, Financial Assets.

1.8 REVIEW QUESTIONS

1. "Money is what money does". Critically examine the statement.

2. Define money. Explain its various functions.

3. Is money a mere medium of exchange? What are the dynamic functions of money?

4. What is money? Explain the classification of money.

5. Define the principal and method of note issue in detail.

1.9 FURTHER READINGS

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LESSON-2
VALUE OF MONEY: MEANING AND THEORIES OF VALUE OF MONEY

STRUCTURE

2.0 OBJECTIVES

At different times, the role of money and its consequent results on the level of prices has been discussed by different authors.

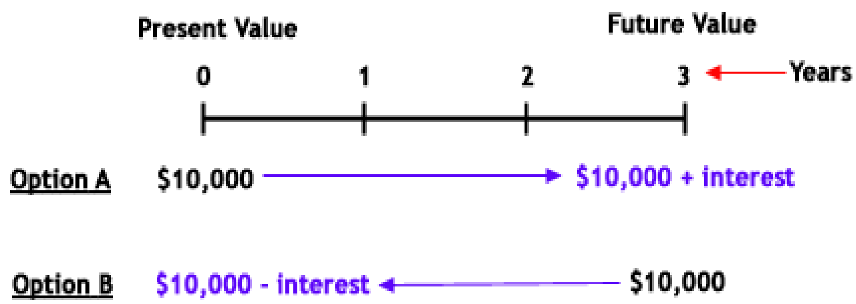
1. To study the certain theories which explain the intricate relationship between the money and level of general price?
2. In this chapter we will discussed the different theories of money such as Quantity theory, Cambridge theory, Friedman theory and Keynesian equations. The general theory by Keynes

came with a bang and revolutionized the economic thinking. Keynesian is of the views that money affects real variable only in the long run.

3. With the help of example, we will try to understand some standard calculations based on the time value of money.

2.1 INTRODUCTION

The value of money, for example the value of rupees note comprises the amount of commodities and services that it helps to purchase. Money purchases more when the prices of commodities and services are low and it purchases less when prices are high. The value of money, implying the purchasing power of money, depends on the level of prices. The value of money cannot be found out directly but only indirectly, through the price level. If you're like most people, you would choose to receive the $10,000 now. After all, three years is a long time to wait. Why would any rational person defer payment into the future when he or she could have the same amount of money now? For most of us, taking the money in the present is just plain instinctive. So at the most basic level, the time value of money demonstrates that, all things being equal, it is better to have money now rather than later. But why is this? A $100 bill has the same value as a $100 bill one year from now, doesn't it? Actually, although the bill is the same, you can do much more with the money if you have it now because over time you can earn more interest on your money. Back to our example: by receiving $10,000 today, you are poised to increase the future value of your money by investing and gaining interest over a period of time. For Option B, you don't have time on your side, and the payment received in three years would be your future value. To illustrate, we have provided a timeline:



If you are choosing Option A, your future value will be $10,000 plus any interest acquired over the three years. The future value for Option B, on the other hand, would only be $10,000. So how can you calculate exactly how much more Option A is worth, compared to Option B? Let's take a look.

2.2 DEFINITION AND MEANING

In the words of Crowther**,** "The value of money is what it will buy." The amount of goods and services received in exchange for a unit of money constitutes value of money. If in exchange for one rupee one gets two pencils, then the value of the rupee will be two pencils. According to Robertson, "By the value of money we mean the amount of the things in general which will be given in exchange for a unit of money." Value for money is based not only on the minimum purchase price (economy) but also on the maximum efficiency and effectiveness of the purchase. The time value of money is the value of money figuring in a given amount of interest earned or inflation accrued over a given amount of time. The ultimate principle suggests that a certain amount of money today has different buying power than the same amount of money in the future. This notion exists both because there is an opportunity to earn interest on the money and because inflation will drive prices up, thus changing the "value" of the money. The time value of money is the central concept in finance theory.

For example, \$100 of today's money invested for one year and earning 5% interest will be worth \$105 after one year. Therefore, \$100 paid now or \$105 paid exactly one year from now both have the same value to the recipient who assumes 5% interest; using time value of money terminology, \$100 invested for one year at 5% interest has a future value of \$105. This notion dates at least to Martín de Azpilcueta (1491–1586) of the School of Salamanca.

The method also allows the valuation of a likely stream of income in the future, in such a way that the annual incomes are discounted and then added together, thus providing a lump-sum "present value" of the entire income stream.

All of the standard calculations for time value of money derive from the most basic algebraic expression for the present value of a future sum, "discounted" to the present by an amount equal to the time value of money. For example, a sum of FV to be received in one year is discounted (at the rate of interest **r**) to give a sum of PV at present:

$$PV = FV - r \cdot PV = FV / (1+r).$$

Some standard calculations based on the time value of money are:

Present value: - The current worth of a future sum of money or stream of cash flows given a specified rate of return. Future cash flows are discounted at the discount rate, and the higher the discount rate, the lower the present value of the future cash flows. Determining the appropriate discount rate is the key to properly valuing future cash flows, whether they are earnings or obligations.

Present value of an annuity: - An annuity is a series of equal payments or receipts that occur at evenly spaced intervals. Leases and rental payments are examples. The payments or receipts occur at the end of each period for an ordinary annuity while they occur at the beginning of each period for an annuity due.

Present value of perpetuity: - It is an infinite and constant stream of identical cash flows.

Future value:- It is the value of an asset or cash at a specified date in the future that is equivalent in value to a specified sum today.

Future value of an annuity: - It is the future value of a stream of payments (annuity), assuming the payments are invested at a given rate of interest.

Value of Money and Price Level: - The value of money is closely related to the prices of goods and services. As money is used as a unit of account and as a measure of value of all other things, its own value can be measured only through the prices of other things. The value of money therefore depends upon the level of prices of goods and services to be purchased with money. The lower the price level, the greater will be the purchasing power of money and the higher will be the value of money; the higher the price level, the smaller will be the purchasing power of money and the lower will be the value of money. Hence, there is inverse relationship between the value of money (or the purchasing power of money) and the price level. The value of money is, thus, the reciprocal of the price level.

Symbolically,

$$Vm = \frac{1}{P}$$

Where, Vm stands for the value of money, and

P stands for the price level.

Let us illustrate the relationship between value of money and price level with the help of an example.

Price of salt is Rs. 10 per k.g. Here, a unit of money, i.e. one rupee can buy 100 grams of salt. So, in this example value of money is 100 grams of salt. If the price falls to Rs. 8 per k.g., the value of money will increase to 125 grams of salt because now one rupee can buy 125 grams salt.

The value of money is of two types:-

(i) The internal value of money and

(ii) The external value of money.

The internal value of money means the purchasing power of money over domestic goods and services. The external value of money means the purchasing power of money over foreign goods and services.

2.3 THEORIES OF VALUE OF MONEY

The concept of the quantity theory of money (QTM) began in the 16th century. As gold and silver inflows from the Americas into Europe were being minted into coins, there was a resulting rise in inflation. This led economist Henry Thornton in 1802 to assume that more money equals more inflation and that an increase in money supply does not necessarily mean an increase in economic output. Here we look at the assumptions and calculations underlying the QTM, as well as its relationship to monetarism and ways the theory has been challenged.

2.3.1 QUANTITY THEORY OF MONEY (QTM)

The quantity theory of money states that there is a direct relationship between the quantity of money in an economy and the level of prices of goods and services sold. According to QTM, if the amount of money in an economy doubles, price levels also double, causing inflation (the percentage rate at which the level of prices is rising in an economy). The consumer therefore pays twice as much for the same amount of the good or service.

Another way to understand this theory is to recognize that money is like any other commodity: increases in its supply decrease marginal value (the buying capacity of one unit of currency). So an increase in money supply causes prices to rise (inflation) as they compensate for the decrease in money's marginal value.

The Theory's Calculations

In its simplest form, the theory is expressed as:

MV = PT (the Fisher Equation)

Each variable denotes the following:

M = Money Supply

V = Velocity of Circulation (the number of times money changes hands)

P = Average Price Level

T = Volume of Transactions of Goods and Services

The original theory was considered orthodox among 17th century classical economists and was overhauled by 20th-century economists Irving Fisher, who formulated the above equation, and Milton Friedman. It is built on the principle of "equation of exchange":

Amount of Money x Velocity of Circulation = Total Spending

Thus if an economy has US$3, and those $3 were spent five times in a month, total spending for the month would be $15.

Assumptions

QTM adds assumptions to the logic of the equation of exchange. In its most basic form, the theory assumes that **V** (velocity of circulation) and **T** (volume of transactions) are constant in the short term. These assumptions, however, have been criticized, particularly the assumption that V is constant. The arguments point out that the velocity of circulation depends on consumer and business spending impulses, which cannot be constant.

The theory also assumes that the quantity of money, which is determined by outside forces, is the main influence of economic activity in a society. A change in money supply results in changes in price levels. It is primarily these changes in money stock that cause a change in spending. And the velocity of circulation depends not on the amount of money available or on the current price level but on *changes* in price levels.

Finally, the number of transactions (**T**) is determined by labor, capital, natural resources (i.e. the factors of production), knowledge and organization. The theory assumes an economy in equilibrium and at full employment.

Essentially, the theory's assumptions imply that the *value* of money is determined by the *amount* of money available in an economy. An increase in money supply results in a decrease in the value of money because an increase in money supply causes a rise in inflation. As inflation rises, the purchasing power, or the value of money, decreases. It therefore will cost more to buy the same quantity of goods or services.

(1) Velocity of money in circulation (V) remains constant:

According to Fisher the velocity of money in circulation (V) remains constant and the changes in the quantity of money cannot influence it (V).

(2) Total volume of transactions or trade remains constant: Total volume of transactions or trade (T) too, remain constant or unchanged and is not affected by the changes in the quantity of money.

(3) Price level (P) is a passive factor: According to Fisher, the price level (P) is a passive factor in the equation of exchange which is affected by the other factors of the equation.

(4) Money is a medium of exchange: The quantity theory of money assumed that money is used only as a medium of exchange.

(5) Long period: The cash transactions approach to the quantity theory of money is based on the assumption of long period.

Criticism of the theory

The quantity theory s subjected to the following criticism.

Unrealistic assumptions: The theory is based on unrealistic assumptions. In this theory P is considered as a passive factor. T is independent. M1, V, V1, are constant in the short run. All these assumptions are covered under "Other things remaining the same." In actual working of the economy, these do not remain constant; hence, the theory is unrealized and misleading.

Various Variables in the transaction are not independent: The various variables in transaction equation are not independent as assumed in the theory The fact is that they very much influence each other For example when money supply (M) increases the velocity f money (V) also goes up Take another case. Fisher assumes (P) is a passive factor and has no effect on trade (T). In actual practice, when price level P) rises, it increases profits and promotes trade (T).

Assumption of full employment is wrong: J. M. Keynes has raised en objection that the assumption of full employment is a rare phenomenon in the economy and the theory is not real.

Rate of interest ignored: In the quantity theory of Fishers, the influence of the rate of interest on the money supply and the level of prices have been completely ignored. The fact is that an increase or decrease in money supply has an important bearing on the rate: of interest. An increase in money supply leads to a decline in the rate of interest and vice versa.

Fails to explain trade cycles: This theory fails to explain the trade cycles. It does not tell as to why during depression, the increase in money supply has little impact on the price level, Similarly, in boom period the reduction in money supply or tight money policy may not bring down the price level. G. Crowther is right in saying, "The quantity theory is at best an imperfect guide to the cause of the business cycle".

Ignores other factors of price level: There are many determinants other than M, V, and T which have important implication on the price level. These factors such as income, expenditure, saving, investment, population consumption etc have been ignored from the purview of the theory.

2.3.2 CAMBRIDGE THEORY

As an alternative to Fisher's quantity theory of money, Marshall, Pigou, Robertson, Keynes, etc. at the Cambridge University formulated the Cambridge cash-balance approach. Fisher's transactions approach emphasized the medium of exchange functions of money. On the other hand, the Cambridge cash-balance approach was based on the store of value function of money. According to cash-balance approach, the demand for money and supply of money determine the value of money. This approach, considers the demand for money and supply of money at a particular moment of time. Since, at a particular moment the supply of money is fixed, it is the demand for money which largely accounts for the changes in the price level. As such, the cash-balance approach is also called the demand theory of money. The Cambridge cash-balance approach considers the demand for money not as a medium of exchange but as a store of value. The actual demand for money comes from those who want to hold want to exchange it for goods and services. Thus, according to Cambridge cash-balance approach, the demand for money implies demand for cash balances. According to Cambridge cash-balance approach for the given supply of money at a point of time, the value of money is determined by the demand for cash balances. Cash balance is that proportion of the real income which the people desire to hold in the form of money. When people increase their demand for money, they will reduce their expenditures on goods and services in order to have larger cash holdings. As a result demand for goods and services will fall. Fall in demand for goods and services will reduce the price level and raise the value of money. Conversely, fall in the demand for money will raise the price level and will reduce the value of money.

The Cambridge cash-balances equations of Marshal, Pigou, Robertson and Keynes are stated as under:

Marshall's Equation

The Marshallian cash-balance equation is expressed as follows :

MV = KPY

Where

M is the supply of money (currency plus demand deposits)

P is the price level

Y is aggregate real income; and

K is the fraction of the real income which the people desire to hold in the form of money. The value of money (1/p) (or, the purchasing power of money), in terms of this equation, can be found out by dividing the total quantity of goods which the people desire to hold out of the total income (KY) by the total supply of money (M). Thus,

$$\frac{1}{P} = \frac{KY}{M}$$

Similarly, the price level (P) can be found out by dividing the total money supply (M) by the quantity of goods which the people desire to hold out of the total income (KY). Thus,

$$P = \frac{M}{KY}$$

Thus, for example, if M is Rs. 10,000, Y is 1,00,000 units, K is .5, then the value of money (1/p) willbe

$$\frac{KY}{M} = \frac{5 \times 1,00,000 \text{ units}}{Rs.10,000} = 5 \text{ units of goods per rupee}$$

and the price level (P) will be

$$\frac{M}{KY} = \frac{Rs.10,000}{5 \times 1,00,000 \text{ units}} = Rs.\ 1/5 \text{ per unit.}$$

The cash balance approach states that

(i) The price level (P) is directly proportional to the money supply (M);

(ii) The price level (P) is indirectly proportional to the aggregate real income (Y) and the proportion of the real income which people desire to keep in the form of money (K);

(iii) M and Y being constant, with the increase in K price level (P) falls and with the decreases in K price level (P) rises;

(iv) K and Y remaining unchanged, if supply of money (M) increases, price level (P) rises and if supply of money (M) decreases, price level (P) falls.

Pigou's Equation

Pigou's cash balance equation is as follows:

$$\frac{1}{P} = \frac{KR}{M}$$

Where

P is the price level and 1/p is the purchasing power;

R is the total real income or the real resources;

K is the proportion of real income held by the people in the form of money; and

M is the total money supply.

Since money is held by the community in the form of cash and in the form of bank deposits, According to Pigou, K was more significant than M in explaining changes in the purchasing power of money (value of money). This means that the value of money depends upon the demand of the people to hold money. Moreover, assuming K and R to be constant, the relationship between money supply (M) and price level (P) is direct and proportional.

Robertson's Equation:

Robertson's cash balance equation is as follows:

$$M = KPT$$

Where,

P is the price level;

M is the money supply;

T is the total amount of goods and services to be purchased during a year.

K is the proportion of T which people wish to hold in the form cash.

According to Robertson's cash balance equation, P changes directly with M and inversely with K and T.

Keyne's Equation:

Keyne's cash balance equation is as follows:

$$n = pk$$

or $$p = \frac{n}{k}$$

Where

n is the cash held by the general public;

p is the price level of consumer goods;

k is the real balance or the proportion of consumer goods over which cash (n) is kept.

Assuming K to be constant, a change in ‘n’ causes a direct and proportional change in ‘p’. In other words, if the quantity of money in circulation is doubled the price level will also be doubled, provided k remains constant. In order to include bank deposits in money supply,

Keynes extended the equation as follows:

$$P = \frac{n}{k + rk'}$$

Where,

r is the cash reserve ratio of the banks;

k’ is the real balance held in the form of bank money.

Again, assuming k, k’ and r to be constant, a change in ‘n’ causes a direct and proportional change in ‘p’.

Criticism of cash-balance approach:

The cash-balance approach has been criticized on the following grounds:

(1) Like Fisher’s transaction equation, MV = PT, the Cambridge equation, M = KPY, is also a simple truism.

(2) The cash-balance approach is based on the assumption that the demand for money has uniform unitary elasticity. (This means that an increase in the desire for holding cash balance (K) leads to equi-proportionate fall in the price level). This is an unrealistic assumption.

(3) The cash balance approach has not properly analyzed various motives for holding money. For example, it ignored the speculative motive for holding money which causes violent changes in the demand for money.

(4) A serious defect in the Cambridge equations (furnished by Pigou and Keynes) is that they seek to explain the value of money (or, the purchasing power of money) in terms of consumption

goods only and ignored the investment goods altogether. Thus cash balance approach has unduly narrowed down the conception of the purchasing power of money.

(5) The cash-balance approach ignored the role of rate of interest in explaining the changes in the price level. The rate of interest has a definite influence on demand for money and, in turn, on the price level.

(6) The approach ignored the influence of real factors like, income, saving, investment, etc. on the price level.

(7) The cash balance approach ignored the real-balance effect which means that

(i) An individual's wealth is influenced by the changes in money balances and the price level;

(ii) The changes in wealth further influence the expenditure on goods.

(8) The approach viewed the real income as the sole determinant of K. It has ignored the influence of price level, banking and business habits of the people, business integration, etc. on the value of K.

(9) The approach maintains that the value of money or the price level (P) is determined by K. But it has been pointed out that K not only influences P but K is also influenced by P.

(10) In terms of cash balance approach it is difficult to visualize, the extent to which prices and output will change as a result of a given change in the supply of money. Thus the approach lacks quantitative analysis.

(11) Like Fisher's Transactions approach, the Cambridge approach also assumes K and T as given. But it is possible only in a static situation and not in dynamic situation.

(12) Like Fisher's transactions approach, the Cambridge approach also provides no explanation for trade cycle.

In spite of the various shortcomings, the Cambridge cash balance approach is not entirely useless. The great merit of the Cambridge approach is the analysis of demand for money as an important determinant of value of money.

Superiority of Cambridge Quantity Theory of Money over Fisher's Version

The cash-balances approach represents an advance over the cash transactions approach in many respects:

1. Humanistic Approach:

The Cambridge equations emphasize K or cash-balances and consider human motives as important factors affecting the price level, as opposed to the mechanistic nature of the cash-transactions equation.

Fisher's equation, on the other hand, is mechanistic in the sense that it does not explain how changes in the volume of money bring about alterations in the price level. The Cambridge equations attempt to bring out the causal factors involved; a change in the desire to hold money may bring about alterations in the price level, even without there being any change in the quantity of money.

2. Better Mode of Thinking:

The Cambridge version is concerned with the level of income as against Fisherian consideration of the total number of transactions. This notion has paved the way for a new mode of thinking in modern economics.

3. Integration of the Theory of Money with the General Theory of Value:

Fisher's approach is only one-sided in the sense that it considers supply of money to be the only effective element in determining the value of money. The Cambridge equations, on the other hand, are stated in terms of supply and demand both following the general theory of value.

4. More Realistic Approach:

The cash-balances equation emphasizes the psychological factors or subjective valuations as chief determinants of the demand for money, in contrast to the Fisherian approach which stresses the institutional, objective and technological [factors only. Thus, the former is more realistic, because [the fundamental truth about money is that someone always holds it.

5. Foundation of Modern Theory of Interest and Demand for Money:

The cash-balances theory has sown the seeds of the Keynesian Liquidity Preference Theory of Interest as well as the modern concept of the demand for money. It points out two of the three liquidity motives, viz., the transactions and precautionary motives.

6. More Convenient Equation:

Kurihara states that the Cambridge equation P = KT/M is far better than the cash-transactions equation P = MV/T in explaining money value, because it is more convenient to know the amount of the cash-balances individuals hold relative to total expenditure than to know how much they spend for a multitude of transactions.

2.3.3 FRIEDMAN'S THEORY OF MONEY

As restated by Milton Friedman, the quantity theory emphasizes the following relationship of the nominal value of expenditures PQ and the price level P to the quantity of money M:

$$(1) PQ = f(\overset{+}{M})$$

$$(2) P = g(\overset{+}{M})$$

The plus signs indicate that a change in the money supply is hypothesized to change nominal expenditures and the price level in the same direction (for other variables held constant).

Friedman described the empirical regularity of substantial changes in the quantity of money and in the level of prices as perhaps the most-evidenced economic phenomenon on record.[21] Empirical studies have found relations consistent with the models above and with causation running from money to prices. The short-run relation of a change in the money supply in the past has been relatively more associated with a change in real output Q than the price level P in (1) but with much variation in the precision, timing, and size of the relation. For the long-run, there has been stronger support for (1) and (2) and no systematic association of Q and M.

Principles

The theory above is based on the following hypotheses:

1. The source of inflation is fundamentally derived from the growth rate of the money supply.
2. The supply of money is exogenous.
3. The demand for money, as reflected in its velocity, is a stable function of nominal income, interest rates, and so forth.
4. The mechanism for injecting money into the economy is not that important in the long run.
5. The real interest rate is determined by non-monetary factors: (productivity of capital, time preference).

Milton Friedman (another Nobel Prize winner) developed a model for money demand based on the general theory of asset demand. Money demand, like the demand for any other asset, should be a function of wealth and the returns of other assets relative to money. His money demand function is as follows:

$$\left(\frac{M^d}{P}\right) = f\left(Y_p, r_b - r_m, r_e - r_m, \pi_e - r_m\right)$$

Where Yp = permanent income (the expected long-run average of current and future income)

rb = the expected return on bonds

rm = the expected return on money

re = the expected return on stocks

pi(e) = the expected inflation rate (the expected return on goods, since inflation is the increase in the price (value) of goods.

Money demand is positively related to permanent income. However, permanent income, since it is a long-run average, is more stable than current income, so this will not be the source of a lot of fluctuation in money demand

The other terms in Friedman's money demand function are the expected returns on bonds, stocks and goods relative the expected return on money. These items are negatively related to money demand: the higher the returns of bonds, equity and goods relative the return on money, the lower the quantity of money demanded. Friedman did not assume the return on money to be zero. The return on money depended on the services provided on bank deposits (check cashing, bill paying, etc) and the interest on some checkable deposits.

Friedman vs. Keynes

When comparing the money demand frameworks of Friedman and Keynes, several differences arise

- Friedman considers multiple rates of return and considers the relative returns to be important
- Friedman viewed money and goods and substitutes.

- Friedman viewed permanent income as more important than current income in determining money demand

Friedman's money demand function is much more stable than Keynes'. Why? Consider the terms in Friedman's money demand function:

- permanent income is very stable, and
- the spread between returns will also be stable since returns would tend to rise or fall all at once, causing the spreads to stay the same. So in Friedman's model changes in interest rates have little or no impact on money demand. This is not true in Keynes' model.

If the terms affecting money demand are stable, then money demand itself will be stable. Also, velocity will be fairly predictable.

2.3.4 KEYNESIAN EQUATIONS

In monetary economics, the quantity theory of money is the theory that money supply has a direct, proportional relationship with the price level. For example, if the currency in circulation increased, there would be a proportional increase in the price of goods.

The theory was challenged by Keynesian economics, but updated and reinvigorated by the monetarist school of economics. While mainstream economists agree that the quantity theory holds true in the long run, there is still disagreement about its applicability in the short run. Critics of the theory argue that money velocity is not stable and, in the short-run, prices are sticky, so the direct relationship between money supply and price level does not hold.

Equation of exchange in its modern form, the quantity theory builds upon the following definitional relationship.

$$M \cdot V_T = \sum_i (p_i \cdot q_i) = \mathbf{p}^{\mathrm{T}}\mathbf{q}$$

Where

M is the total amount of money in circulation on average in an economy during the period, say a year.

V_T is the transactions velocity of money, that is the average frequency across all transactions with which a unit of money is spent. This reflects availability of financial institutions, economic variables, and choices made as to how fast people turn over their money.

p_i and q_i are the price and quantity of the i-th transaction.

$\mathbf{p}$ is a column vector of the p_i, and the superscript $^{\mathrm{T}}$ is the transpose operator.

$\mathbf{q}$ is a column vector of the q_i.

Mainstream economics accepts a simplification, the equation of exchange:

$$M \cdot V_T = P_T \cdot T$$

Where

P_T is the price level associated with transactions for the economy during the period

T is an index of the real value of aggregate transactions.

The previous equation presents the difficulty that the associated data are not available for all transactions. With the development of national income and product accounts, emphasis shifted to national-income or final-product transactions, rather than gross transactions. Economists may therefore work with the form

$$M \cdot V = P \cdot Q$$

Where

V is the velocity of money in final expenditures.

Q is an index of the real value of final expenditures.

As an example, M might represent currency plus deposits in checking and savings accounts held by the public, Q real output (which equals real expenditure in macroeconomic equilibrium) with P the corresponding price level, and $P \cdot Q$ the nominal (money) value of output. In one empirical formulation, velocity was taken to be "the ratio of net national product in current prices to the money stock".

Thus far, the theory is not particularly controversial, as the equation of exchange is an identity. A theory requires that assumptions be made about the causal relationships among the four variables in this one equation. There are debates about the extent to which each of these variables is dependent upon the others. Without further restrictions, the equation does not require that a change in the money supply would change the value of any or all of P, Q, or $P \cdot Q$. For example, a 10% increase in M could be accompanied by a 10% decrease in V, leaving $P \cdot Q$ unchanged. The quantity theory postulates that the primary causal effect is an effect of *M* on *P*.

Criticisms of Keynes Thesis of Money and Prices

Keynes views on money and prices have been criticized by the monetarists on the following causes:

1. Direct Association
2. Stable Demand for Money
3. Nature of Money and
4. Effect of Money

1. Direct Association: Keynes misguidedly took prices as unchangeable and that the effect of money materializes in his scrutiny in terms of quantity of goods exchanged somewhat than their average prices.

That is why Keynes adopted an indirect mechanism through bond prices, interest rates and investment of the effects of fiscal variations on monetary performance. But the actual effects of monetary variations are direct somewhat than meandering.

2. Stable Demand for Money: Keynes believed that monetary variations are largely absorbed by variations in the demand for money. But Friedman has depicted on the basis of his pragmatic examines that the demand for money is hugely invariable.
3. Nature of Money: Keynes was unsuccessful in understanding the true nature of money. He assumed that money could be exchanged for bonds only. Actually, money can be exchanged for many diverse kinds of like wealth like bonds, physical assets, securities human wealth etc.
4. Effect of Money: Because Keynes wrote for a depression period, this led him to conclude that money had little effect on earnings. According to Friedman, it was the retrenchment of money that impetuous the depression.

   It was thus, incorrect on the part of Keynes to argue that money had little effect on earnings. Money does affect national earnings.

2.4 SUMMARY

Value of money means the purchasing power of money or its buying capacity. It refers to the quantity of goods and services that can be bought by a unit of money.

The value of money is closely related to the prices of goods and services. Money measures the value of other things. The value of money can be measured through the prices of other things. The value of money depends upon the level of prices of goods and services to be purchased with money.

The quantity theory of money states that the quantity of money is the main determinant of the value of money or the price level.

According to this theory, due to the changes in the quantity of money the value of money changes. **Irving Fisher** provided the transactions approach of the quantity theory of money. According to Fisher, 'other things remaining unchanged, as the quantity of money in circulation increases, the price level also increases in direct proportion and the value of money decreases and vice versa.' Fisher explained his quantity theory of money with the help of his famous equation of exchange:

$$MV = PT$$

or, $$P = \frac{MV}{T}$$

Fisher further expanded his equation of exchange to

$$MV + M'V' = PT$$

or $$P = \frac{MV + M'V'}{T}$$

According to the transactions approach to the quantity theory of money, other things remaining the same, i.e., if V, and T remain unchanged, there exists a direct and proportional relation between the quantity of money and the price level. Fisher explained his transactions approach to the quantity theory of money on the basis of some assumptions such as, velocity of money in circulation remains constant, total volume of trade remains constant, price level is a passive factor; money is a medium of exchange, etc. The theory has been criticized on some grounds such as, variables are not independent, a simple truism, unrealistic assumption of long period, unrealistic assumption of full employment, static theory, technically inconsistent, fails to explain trade cycles, ignores the store of value function of money, etc.

Cambridge cash-balance approach was formulated by Marshall, Pigou, Robertson, Keynes, etc. at the Cambridge University. According to this approach, the demand for money and supply of money determine the value of money. Cash-balance approach, considers the demand for money and supply of money at a particular moment of time. The approach considers the demand for money not as a medium of exchange but as a store of value. According to cash-balance approach, given the supply of money at a point of time, the value of money is determined by the demand for cash-balance.

Marshall has given his own equation as:

$$M = KPY$$

In terms of this equation, the value of money (1/p) can be found out by dividing the total quantity of goods which the people desire to hold out of the total income (KY) by the total supply of money (M). Thus,

$$\frac{1}{P} + \frac{KY}{M}$$

Like Fisher's transactions approach, cash-balance approach has been also criticized on certain grounds such as, it is also a simple truism, unrealistic assumption of uniform unitary elasticity, speculative motive for holding money ignored, investment goods ignored, role of rate of interest ignored, influence of real factors ignored, real-balance affect ignored, no explanation to trade cycles, etc.

2.5 KEYWORDS

Future Value, Present Value, Cambridge Theory, Friedman Theory, Fisher's Theory, Keynesian Equations, Retrenchment of Money, Bonds, Physical Assets, Securities, Human Wealth, Medium of Exchange.

2.6 REVIEW QUESTIONS

1. What do you mean by value of money?
2. State the statement of the quantity theory of money.
3. Write five assumptions of quantity theory of money.
4. Briefly state the Cambridge cash-balance approach.
5. Write five criticisms of cash-balance approach.

2.7 FURTHER READINGS

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LESSON-3

ECONOMIC FLUCTUATIONS AND THEIR IMPACT ON ECONOMIC GROWTH STRUCTURE

3.0 OBJECTIVES

In this chapter discuss how Inflation is the persistent rise in general level of prices of goods and services in economy. When the price of petrol, diesel and essential commodities like rice, wheat, cooking gas go up and people spend more money for the same goods and services then it is inflation. It is a situation where too much money chases too few goods and services. Inflation is a rise in the general level of prices and is measured in percentage. Essentially inflation indicates that the value of money is going down and it takes more money to buy the same basket of goods.

Therefore, a four percent inflation rate means the price level has raised four percent form a certain base year.

1. The objective of the chapter is to discuss the types of inflation and various causes of inflation which affect the economic growth.
2. Apart of this, we will discuss the meaning of deflation and its several causes that impact on the economic growth.
3. To study about the stagflation and to examine its various causes.

3.1 INTRODUCTION

Inflation may arise due to increase in the supply of money. It may also be the result of an increase in the supply of money that exceeds the increase in the supply of commodities. Inflation generally is regarded as an increase in the average level of prices or general increase in prices or sometimes an increase in the prices of commonly used goods like oil or foodstuffs. Inflation generally is regarded as a situation where increase in money supply outruns the increase in the supply of goods and services. The cause of inflation as pointed out by different economists is increase in the quantity of money. Thus inflation consists of a large increase in the available quantity of money and money substitutes such as bank credits.

To measure inflation, economists select a variety of goods and construct a price index such as the Wholesale Price Index (WPI). The WPI is a measure of the inflation rate in India. However, there is no single true measure of inflation, because the value of inflation will depend on the weight given to each good in the index. Examples of common measure of inflation include:

- Consumer Price Indexes (CPIs) which measure the price of a selected basket of goods by a "typical consumer". In many industrial nations, annualized percentage change in these indexes is the most commonly used measure of inflation. These measures are often used in wage and salary negotiations, since employees wish to have a hike in wages and salaries that compensate for the decline in the real purchasing power of money.

- Product Price Indexes (PPIs) measure the price received by a producer. The subsidies and tax incentives paid by the government to the producer may inflate or deflate the amount received by the producer. There might also be a delay between a rise in the PPI and consequent increase in the CPI.
- Wholesale Price Indexes measure the change in the price of a selected basket of goods at wholesale i.e., prior to sales taxes. Inflation in India is viewed in terms of the wholesale price index.
- Commodity Price Indexes measure the change in price of a selection of commodities. In the case of the gold standard the sole commodity used was gold.
- GDP deflator is also a measure of inflation which deflates the national income. It is based on the ratio of the total amount of money spent on GDP to the inflation-corrected measure of GDP constant-price or "real" GDP. It is the broadest measure of inflation.

3.2 INFLATION- DEFINITION AND MEANING

The dictionary meaning of the word inflation is expansion or an act of inflating. When the bladder of football is filled with air, it is inflated. In the context of prices, inflation means persistent rise in general price-level.

Definitions

Different economists have given different definitions of Inflation from time to time.

(1) In the words of **Peterson**, "The word inflation in the broadest possible sense refers to any increase in the general price-level which is sustained and non-seasonal in character."

(2) According to **Samuelson**, "By inflation we mean a time of generally rising prices"

(3) In the words of **Shapiro**, "Inflation is simply a persistent and appreciable rise in general price-level."

(4) According to **Kemmerer**, "Inflation is too much money and deposit currency that is too currency in relation to the physical volume of business being done."

(5) **Gregory** defines it in these terms, "Inflation is an increase in the quantity of purchasing power."

(6) In the words of Johnson, "Inflation is an increase in the quantity of money faster than real national output is expanding."

(7) According to **Coulbourn**, "Inflation is the stage of too much money chasing too few goods:

In short, Inflation is the process of persistent increase in the price level.

Keynesian view of Inflation

Keynes has explained Inflation on the basis of employment. He has divided it into two parts:

(1) Semi-Inflation: Increase in the quantity of money before full employment leads to increase in output and employment. Consequently, prices do not increase in the same proportion as the quantity of money. Increase in price level prior to full employment has been termed Semi-inflation by Keynes. Such inflation is mainly due to hindrances in the mobility of factors of production. It is also called Bottleneck Inflation.

(2) Open or Full Inflation: Increase in the quantity of money after full employment leads to rise in the price-level which is called open, full, true or absolute inflation by Keynes. It is because due to increase in the effective demand there is no possibility of increase in the production of goods, as all factors of production are fully employed. In the words of Dillard, "There is a true inflation when effective demand for consumer goods plus effective demand for investment goods exceeds the total value of output at full employment in terms of existing prices."

3.2.1 TYPES OF INFLATIONS

There are many types of inflation. It can be classified on the basis or the following:

(1) Classification On the Basis of the Degree of Government Control

Inflation can be divided into two parts:

(i) Open Inflation: It refers to a situation in which no steps are taken to control rising prices. According to Milton Friedman, open inflation is a process in which prices are allowed to rise without any attempt on the part or the government to control them. In this situation prices continue to rise according to demand and supply conditions. Under open inflation, goods are distributed through price mechanism. It means, those people who have large amount to spend buy more goods. Inflation that took place in Germany in the post World War I era was a characteristic example of open inflation.

(ii) Suppressed Inflation: Suppressed inflation refers to a situation in which rising prices are checked by administrative measures like rationing, price control, etc. by the government. Thus prices are checked from rising in the present by the government but as the controls are lifted in future, prices begin to rise rapidly. According to **Horselield** in this situation when people's expenditure is brought down by controls then inflation manifests itself in the form of cash with the people, change in bank deposits and cash or large hoardings of private wealth. Under suppressed inflation because of inexperienced and corrupt officials responsible for administering price control and rationing, black market raises its ugly head According to **Prof. Friedman,** suppressed inflation is dangerous than open inflation.

Under suppressed inflation price mechanism becomes inoperative. Economists like **Milton Friedman** and **Halm** are of the opinion that open inflation is more appropriate than suppressed inflation. It is because under suppressed inflation due to rationing and price control evils like black market, corruption and bribery crop up and resources are inequitably distributed.

(2) Classification on the Basis of Political Conditions

On the basis of political conditions, inflation is classified into three categories:

(i) **War Time Inflation:** In order to meet war expenses government increases the supply of money. Large proportion of production is bought by the government itself. Relatively small proportion of production is available to the people. As a result prices begin to shoot up. Thus inflation that takes place during the course of war is called War Time Inflation.

(ii) **Post-War Inflation:** Tendency of inflation persists even after the war mainly due to two reasons. Firstly, government has to spend large amounts on the repair and reconstruction of damage property like, bridges, railway lines, ships, machines, etc. Secondly, taxes levied during war are abolished and loans taken from public are repaid. Consequently, money supply with the public increases but production of goods and services does not increase in the same proportion. Thus prices continue to rise even after the war.

(iii) **Peace Time Inflation:** Under-developed countries need large resources for economic planning and development programmes. In order to mobilize resources, government has to resort to deficit financing. It leads to rise in prices which are popularly known as Peace Time Inflation.

(3) Classification on the Basis of Rate of Inflation

On this basis inflation is classified as under:

(i) **Creeping Inflation:** It refers to that inflation wherein prices rise very slowly. Such inflation is not detrimental to the economy. It is not only beneficial to the economy but is also considered essential to some extent. Some economists are of the view that 3% rise in prices can be called creeping inflation. They regard it appropriate and desirable in the interest of national development. Some other economists apprehend danger from creeping inflation at it may assume alarming proportions.

(ii) **Walking Inflation:** When price-rise becomes intense and quantum of inflation gains momentum it is called walking inflation. When, over a decade, prices rise between thirty and forty percent, it is called Walking Inflation.

(iii) **Running or Galloping Inflation:** When there is a rapid increase in prices in differs period it is called running inflation. In this case, rate of inflation is between eighty and hundred percent over a decade. Such inflation has an adverse affect on middle and poor classes. It discourages saving. Such a situation warrants stringent measures to curb inflation.

(iv) **Hyper Inflation:** It refers to a situation when prices rise at an unexpected rate. There is an escalation of price rise. It is called Hydra-headed monster of inflation. It puts the entire economy out of gear. It was this kind of inflation that was witnessed in Germany after 1932 and which made the people loses all confidence in German currency. At one time prices rose 1 million times over a period of one year in Germany. This resulted into utter confusion in the economy. It completely wiped away fixed income groups and poor classes of the society.

(4) **Classification on the Basis of Scope**

On the basis of scope inflation is divided into two parts:

(i) Sectoral or Sporadic Inflation: When inflation affects only a particular part of the country or covers only one or two goods, like pulses, petrol, etc. It is called sporadic inflation.

(ii) Comprehensive Inflation: When inflation is not confined to a given part of the country or a few goods, but engulfs the entire country and all goods, then it is called comprehensive inflation.

(5) Classification According to Process

On the basis of process of rise in prices, inflation is divided into following parts:

(i) Wage Induced Inflation: Powerful labour organizations have strong bargaining power vis a vis the employers. They succeed in getting their wages increased. This results into higher cost of production and increased prices. Such a rise in prices is called wage induced inflation.

(ii) Profit Induced or Mark- up Inflation: In developed countries like America, etc. big companies while fixing the price of their commodities add a given percentage of profit to the costs. This act is called 'mark-up'. These companies keep the 'mark-up' quite high. Consequently, prices of the commodities rise very high and inflation takes place. Such inflation is called mark-up inflation.

(iii) Deficit Induced Inflation: Such inflation is the outcome of deficit financing by the government. It takes place due to increase in money supply in the wake of deficit financing, without any corresponding increase in the supply of goods and services.

(iv) Stagflation: In the post 1970s a new kind of situation arose in the developed countries of the world. These countries on the one hand witnessed fall in production and rise in unemployment due to fall in aggregate demand but on the other hand there was sharp rise in prices. Stagflation characterizes a situation in which on the one hand prices rise but on the other there is no increase in production and employment. In the words of **Samuelson,** "Stagflation involves inflationary rise in prices and wages at the same time that people are unable to find jobs and firms are unable to find customers for what their plants can produce." Stagflation is quite detrimental.

3.2.2 CAUSES OF INFLATION

Inflation is an outcome of an imbalance in demand for and supply of goods. When demand exceeds supply or cost rises then inflation takes place. Thus causes of inflation have two sides:

(1) Demand side

(2) Supply side.

(1) Causes Related to Demand Side

Demand refers to demand for money to buy goods. Demand for money increases mainly due to the following reasons:

(i) Increase in Public Expenditure: Increase in public expenditure in a country leads to an increase in the purchasing power which in turn leads to more demand for goods and services. But after full employment situation there is no increase in production of goods. As a consequence, prices begin to rise and inflation raises its ugly head. This situation can arise even before full employment when certain bottlenecks in the economy slow down the pace of production.

(ii) Deficit Financing: When government meets its deficit budget by resorting to the policy of deficit financing it leads to increase in the monetary income of the people. However, production does not increase to the extent, demand for goods increases. This causes the prices to rise. Presently, countries like India suffer from inflation due mainly to the policy of deficit financing.

(iii) Cheap Monetary Policy: Cheap money and credit policy also causes excessive increase in supply of money and thereby increase in demand for goods and services but their supply doesn't increase correspondingly. It results into rise in prices. Fall in the bank rate, buying of securities under open-market operations and credit expansion policy of the central bank increase the demand for money. It causes increase in monetary income and consequent increase in prices.

(iv) Increase in Disposable Income: Another cause of inflation is increase in the income of consumers. Demand for goods increases due to increase in consumers' income. When some people by consuming more goods and services make relative improvement in their standard of living then it has a demonstration effect on others. They also imitate their consumption pattern. Even if their present income is low they draw upon their past savings and spend the same on consumption. There is thus an increasing pressure on demand resulting into high prices.

(v) Black Money: Unaccounted money is called black money. It is the outcome of tax evasion. Holders of black money squander it on luxuries and conspicuous consumption. They do not care for the prices. Consequently demand increases and prices rise.

(vi) Increase in Investment: Increase in investment also accounts for inflation. When prospects of profit are quite bright, firms increase their investment. There is more capital formation. Prices of capital goods increase under the pressure of increased demand for the same. Prices of other goods begin to rise in sympathy.

(vii) Reduction in Taxes: Sometimes, when government reduces taxes, people's real and monetary income increase causing increase in their effective demand. This additional purchasing power in the hands of the people stimulates their demand for goods making price-rise inevitable. In case the taxes levied by the government are not fully realized, there is generation of black money and speculative transactions. Such transactions give an additional fillip to inflation.

(viii) Less Public Borrowing: If less public borrowing is resorted to by the government or the old debts are repaid then people have more purchasing power with them to exert pressure of demand on various goods and services leading to rise in their prices.

(ix) Increase in Population: If the growth rate of population is higher than the growth rate of output in the country then demand for goods and services outstrips their supply causing rise in prices.

(x) Increase in Exports: Rising exports push up prices on two counts: (i) More exports mean more income and hence more demand for goods and services by the exporters leading to rise in the prices. (ii) More exports of consumer goods mean less supply for domestic consumption and so rise in their prices.

(1) Causes Related to Supply Side

Supply side refers to that quantity of available goods or output on which people spend their income. In case of inflation supply of goods and services does not increase to the same extent as the demand for them does. As a result there is disequilibrium in the economy. It is this disequilibrium that causes rise in prices. Following factors mainly influence supply side:

(i) Less Production: Fall in production is one of the main reasons of rise in prices. Fall in agricultural or industrial production in relation to demand leads to rise in their prices. Production may fall due to diverse reasons such as, disputes between employers and employees, natural calamities, under-utilization of production capacity, etc.

(ii) Artificial Scarcity: Hoarders and profiteers create artificial scarcity of goods by hoarding the same and thus cause their prices to rise in the market.

(iii) Taxation Policy of the Government: High rates of sales tax, excise duty, corporation tax, expenditure tax, etc. discourage production. Under the situation even when demand for goods remains constant there will be rise in their prices. Thus fall in production gives rise to inflation.

(iv) Shortage of Food grains: In the event of short fall of the production of food grains, pulses, edible oils, etc. their prices shoot up. This shortage may be due to failure of monsoon or more production of cash crops than food crops etc.

(v) Industrial Disputes: Sometimes industrial disputes may culminate in strike or lockout. It causes fall in supply or production and hence rise in prices.

(vi) Technical Changes: New inventions ever take place in this dynamic age of science. Change over to new techniques takes some time, with the result that production goes down. However, technicians and specialists are paid their remuneration during the intervening period. This increases cost of production and decreases supply. Result is inflation.

(vii) Lack of Raw Materials: Lack of raw materials within the country and little hope of its import from abroad reduce production and pushes up prices.

(viii) Natural Calamities: Agricultural production is occasionally exposed to such natural calamities as earthquake, flood, drought, etc. causing heavy fall in it. Therefore, prices of the agricultural products rise very much.

(ix) Productive Set up: Sometimes production pattern in the country undergoes such change that producers begin to produce more and more of luxury goods or basic and heavy goods. It is so because production of these goods is more profitable than mass consumer goods. Consequently, income of the labourers' increases and so also their demand for wage goods. This causes the prices of such goods to rise.

(x) War: Production of consumer goods falls heavily during war time, because production resources are diverted to the production of war-goods. It raises the prices of consumer goods.

(xi) International Causes: In modern times different countries have trade relations with one another. Price-rise in one of the trading countries has its effect on other countries as well. Inflation in one country spreads to other countries through trade. For example, one of the reasons for global inflation in modern times is the price-hike of petrol and petroleum products.

(xii) Industrial Policy of Government: If the government imposes resections or discourages the setting-up of new units of the industry then production will go down and prices rise.

(xiii) Bottlenecks in Production: When the supply of electricity, coal, means of transport, etc. becomes erratic then production slows down. As a consequence, supply falls and prices rise.

3.2.3 IMPACT OF INFLATION ON ECONOMIC GROWTH

Economists are of the view that creeping inflation is beneficial to production, employment and economic development, but when rate of inflation crosses safe-limits then it has adverse affect on production and distribution. It becomes iniquitous. Poor are rendered poorer. Main economic and non-economic effects of inflation are as under:

(1) Effect on Debtors and Creditors: Under inflation debtors are gainers and creditors are losers. Supposing a person borrowed a sum of Rs. 2000 for one year. Subsequently, inflation overtook the economy. When the debtor repays Rs. 2000 to the creditor, under inflationary situation, then he will be returning less purchasing power to the latter than the purchasing power he borrowed earlier. Supposing, prior to inflation when he borrowed Rs. 2000 he could purchase 40 quintals of wheat with it. But on account of inflation price of wheat became twice as high and the said amount could purchase just 20 quintals of wheat. Thus debtor stands to gain and creditor suffers a loss.

(2) Effect on Investors: Investors are of two types (i) those who invest their capital in government securities, debentures, bonds etc. yielding a fixed-interest income and (ii) Those who hold shares of joint-stock companies whose profits fluctuate of these two classes of investors, the former are losers and the latter gainers on account of inflation.

(3) Effect on Fixed Salaried Class: The fixed salaried class includes labourers, clerks, teachers and other employees. They are the biggest losers. It is so because prices of goods and services go on rising but there is very little corresponding rise in their money income. Due to inflation, purchasing power of money falls. Even when there is a little rise in their wages, yet they buy less goods and services than before because of rise in prices.

(4) Effect on Producers or Entrepreneurs: This class gains by inflation because: (i) they produce more to meet rising demand. (ii) They stock large quantity of raw-material bought at pre-inflation prices. (iii) Wages increase less than the prices (IV) those entrepreneurs and traders who repay the loans borrowed earlier stand to gain.

(5) Effect on Agriculturists: Inflation has favourable effect on agriculturists as they belong to producer-class. Prices of agricultural products increase more than their costs.

(6) Effect on Middle Class: This class is also adversely affected by inflation. This class has to maintain its standard of living at a particular level but its sources of income are fixed. According to J. W. Angell, the class that suffered the most and could protect itself the least from inflation was the urban middle class.

(7) Effect on Savings: Inflation hits savings badly. Because of high prices of goods, consumption expenditure of the people goes up and their power to save is drastically curtailed. Moreover, due to fall in the value of money, people lose confidence in it and are averse to saving.

(8) Effects on Employment: In the initial stage of inflation it has good effect on employment. Because of rising prices producers earn extra profits and they are encouraged to produce more. Several new industrial units spring up. Once full employment situation is reached prices begin to rise rapidly and soon galloping inflation is in evidence. As a result, people with low income suffer a lot. Aggregate demand begins to contract and unemployment afflicts the economy.

(9) Effect on Balance of Payments: Because of rising prices under the impact of inflation exports fall and imports rise. Soon the country is confronted with unfavorable balance of payments problem.

(10) Effect on Public Debts: Costs of government projects under completion rise unexpectedly because of rising prices. This very much upsets government budget. The government is obliged to borrow from public. Thus public debt mounts.

(11) Effect on Banks and Insurance Companies: Incomes of traders, industrialists and agriculturists increase. They deposit more funds in the banks and this gives a fillip to the development of banking institutions. Setting up of new industrial units increase the element of risk to cover which, many insurance companies come into being.

(12) Effect on Taxes: Rising prices increase the expenditure of the government, to meet which it has to impose new taxes and enhance the rate of existing taxes.

(13) Controls and Rationing: It becomes difficult for the poor people to buy ordinary consumer goods. Government, therefore, imposes price-control, introduces rationing system and opens fair price shops to enable the poor people to get essential commodities at reasonable prices.

(14) Effect on Resource Allocation: Inflation effects allocation of resources as well. Under capitalism resources are allocated through change in prices. When price of a commodity rises relatively, its demand falls and demands for its related goods rises. As a result of it, high-priced goods will be produced in less quantity and relatively low priced goods will be produced in large quantity. For instance during Gulf War abnormal rise in the price of petrol, production of big cars went down and that of two-wheelers and fuel efficient cars went up. Inflation thus has its effect on re-allocation of resources.

(15) Moral Effect: Inflation results into moral degradation. In order to accumulate more and more wealth, trading community resorts to anti-social activities like profiteering, hoarding, adulteration, etc. **Andrew D. White** in his book, Fiat Money Inflation in France, gave the following description of fiat money inflation in France during the famous French Revolution, "In the leading French cities now arose a luxury and license which was a greater evil than the plundering that ministered to it. In the country, the gambling spirit spread more and more. Nor was the reckless and corrupt spirit confined to businessmen; it began to break out in official circles and public men who a few years before had been thought above all possibility of taint became luxurious, reckless, cynical and finally corrupt." Thus, inflation makes government officials corrupt. Bribery is rampant and moral values suffer decay in the country.

(16) Social and Political Effects: Social and political effects of inflation are more dangerous than economic effects. One of the main reasons that enable Hitler and his Nazi Party to come to power in Germany between 1929 and 1933 was the horrible deluge of inflation that overtook the country. According to **Dr. D.B. Turroni,** "Hitler was the foster child of inflation." Widespread discontentment among the masses let loose by inflation accounted for political upheavals in countries like Italy, Spain, France, etc. In the words of **J.K. Galbraith,** "In a free market in an age of endemic inflation, it is unquestionably rewarding in purely pecuniary term to be speculator or prostitute than a teacher, preacher of policeman."

(17) No Confidence in Money and High Rate of Interest: In the words of **R.G. Hawtrey,** "Inflation causes distrust of money and thereby long term lending is put to a stop, or the lenders demand compensation for the risk of loss of value in the form of a very high rate of interest".

In the words of **Prof C.N. Vakil,** "Inflation may be compared to robbery; both deprive their victim of some possession with the difference that the robber is visible; inflation is invisible; the robber's victim may be one or few at a time, the victims of inflation are the whole nation, the robber may be dragged to a court of law, inflation is legal."

There is a great controversy among economists as to whether inflation has favourable or unfavourable effect on economic development. Some economists are of the view that inflation is necessary to pro-mote economic development. On the other hand, some economists believe that inflation slows down the rate of economic growth and as such inflation is not in the interest of economic development. Before arriving at any conclusion in this regard it is essential to have a detailed study of both the views.

(A) Inflation has a favorable effect on economic development or Inflation promotes development.

Rostow, Robertson, Morris Dobb, Keynes, Kaldor, etc. are of the view that a mild dose of in-flation is essential for economic development. According to **Arthur Lewis,** "Inflation is a by-product of development. " Increase in investment leads to increase in monetary income but not immediate increase in production. It takes time to complete production activities. As a result there occurs an imbalance between demand and supply causing inflation. Inflation promotes economic development because of the following reasons:

(1) Increase in Production: It creates an optimistic atmosphere in the country that provides necessary inducement to invest. Marginal Efficiency of Capital increases. It gives further impetus to investment. Increased investment generates more employment and income. Increased income leads to more demand and hence more production. In this manner, inflation promotes economic development.

(2) Redistribution of Income: Inflation redistributes income in favour of those sections of the society that have the capacity to save, for instance, traders, industrialists, farmers, etc. Income of those people increases less that has little capacity to save. As a whole there is more saving in the country because of this redistribution, more saving leads to more investment which is essential for the rapid rate of economic development.

(3) Source of Capital Formation: According to **Dr. V.K.R.V. Rao** inflation results in **forced savings** in the country. Because of increasing prices large number of people cannot afford to consume most of the things. Hence real consumption goes down and real saving goes up. This increased saving can be used for capital formation.

(4) Self-Liquidating: According to **Prof. Arthur Lewis,** financing of economic development is self-liquidating. It is so because the financial resources used for economic development lead to increase in the money supply, but at the same time there is increase in production capacity. Increased production capacity leads to increased supply of goods and services and hence to increased national income. Out of this increased national income repayment of the financial resources used for economic development can be made.

(5) Mobilization of Productive Resources: Productive resources remain passive in under developed countries. Because of lack of banking facilities people have a tendency to hoard their savings. When the scope of economic activities is enlarged in the wake of inflation then these hoards are taken out for use in productive activities. Consequently, rate of economic development accelerates.

(B) Adverse affect of Inflation on Economic Development or Inflation is a Retarding Factor.

Many economists like **Singer, Haberler, B.R. Shenoy,** etc. are of the view that inflation is a retarding factor. They advance following arguments in support of their contention:

(1) Uncertainty: Inflation pushes up cost of production. Labourers demand higher wages. Industrial disputes are more frequent. There are fluctuations in the demand for and prices of the goods. It imparts an element of uncertainty to the economy. Consequently, economic development is adversely affected.

(2) Adverse Effect on Saving: Purchasing power of money falls due to inflation. Hence, the real value of saving effected in terms of money goes down. It serves as a disincentive to saving.

(3) Unjust: Inflation is unjust. Under its impact rich become richer and poor become poorer, adversely affecting social welfare. Even if national income increases due to inflation it will not be considered proper because it will fail to promote social welfare.

(4) Increase in Conspicuous Consumption: People whose income rises on account of inflation squander away the same in conspicuous consumption, speculative activities, hoarding, etc. Instead of putting the same into some productive channel. It leads to wastage of resources adversely affecting economic development.

(5) Disequilibrium of Balance of Payments: Inflation encourages imports and discourages exports. Prices of imported capital goods and raw materials rise. As a result, balance of payments turns adverse. There develops acute shortage of foreign exchange necessary for economic development. It also has an adverse affect on economic development.

(6) Possibility of Hyper Inflation: Inflation is also criticized on the ground that once it takes place there is no limit to it. Creeping inflation gives way to galloping inflation putting the entire economy out of gear. **Dernburg** and **Mc Dougal** in their book **'Macro Economics'** have observed aptly, "There is always a danger that mild inflation may gradually snowball into hyper inflation. It would be folly to take a flippant attitude towards mild inflation".

It is difficult to reach any conclusion regarding the relation between inflation and economic development. Historically, economic development and inflation have no bearing. For example, between 1870 and 1895 prices fell in America yet the rate of economic development remained high. In India, during first plan period prices remained low yet economic growth was satisfactory. It is evident, therefore, that it is not necessary that inflation may promote neither economic development nor that falling prices may prove conducive to economic growth.

Economists like **Prof. Johnson, Milton Friedman, Nurkse,** etc. are of the view that a mild dose of inflation is useful for economic growth. But one must not be indiscreet. Inflation must be kept well within the manageable limits. Beyond a point it must spell dangers to most sections of the society and may, therefore, impede the process of growth. Inflation must be kept within safe limits. As a matter of fact, economic development depends upon several economic and non-economic factors. It is, therefore, difficult to say with certainly whether inflation promotes or retards economic growth.

3.3 DEFLATION DEFINITION AND MEANING

Deflation can be defined as a situation where prices of essential goods and services decline over time. Deflation generally occurs when supply of goods is faster than the supply of money or income of the people. However sometimes due to technological advancement the supply of goods is much faster than the demand of goods. For instance the prices of the personal computers sharply dropped in recent years. Deflation can due to the following four factors:

- The fall in supply of money
- The rise in supply of other goods and services
- The increase in demand for money
- the fall in supply of other goods and services

Like inflation, deflation has also positive and negative effects on economy. Deflation which arises due to low cost of production resulting from efficient production technique or due to technological advancement is held good for the economy.

Because of this, the supply of goods increases and forces the prices to fall. This is a fine situation in economy as it allows total output growth to remain on a high growth trajectory, profit growth to surge and unemployment to fall without inflationary pressure.

Deflation can be harmful for the economy as well. The famous great depression of the 1930's is an example. Deflation has an adverse impact on the psychology of the investors. It creates an environment of pessimism where outputs, employments profits of business enterprises are all on the decline. Because of such pessimistic conditions in the economy no fresh investment is forthcoming.

3.3.1 CAUSES OF DEFLATION

There are four basic causes of deflation. They are:

1. **Growth Deflation**
2. **Cash-Building Deflation**
3. **Bank Credit Deflation**
4. **Confiscatory Deflation**

1. Growth Deflation

Deflation sometimes arises due to increase in efficiency and productivity .Earlier we discussed the impact of technological improvements on the prices of computers. The common example of this deflation can be noticed in falling prices of technological goods. Growth deflation is a sign of healthy progressing economy. As Selerno notes. "Throughout the nineteenth century and up until the First World War, a mild deflationary trend prevailed in the industrialized nations as rapid growth in the supply of goods outpaced the gradual growth in money supply that occurred under the classical gold standard "Growth deflation desirable as it is by no means harmful.

2. Cash Building Deflation

When the demand for money increase cash–building deflation occurs. All other things remaining constants, an increase in demand for cash balance will raise the interest rate. Thus "hoarding" of money may be responsible for deflationary situation in the economy.

3. Bank Credit Deflation

Commercial bank can create money, which can be a factor contributing to inflation or deflation. When the central bank allow to commercial bank to make advances on large scale and thus creates more money in the system it will lead to inflationary situation. This can be done by central bank by maintaining low cash reserve ratio, Bank rate and statutory liquidity requirement (SLR). Similarly, the central bank can curb the power of commercial banks to create money by maintaining high cash reserve ratio, bank rate and statutory liquidity ratio (SLR). It will lead to a deflationary situation. Salerno writes that " the most familiar is a decline in the supply of money that result from a collapse or contraction fractional- reserve banks that are called upon by their depositors to redeem their notes and demand deposits in the cash during financial crises".

4. Confiscatory Deflation

There are also confiscatory deflations which can be characterized as bad deflation. It was a forced deflation imposed upon people by exercising political power. The most recent example of this kind of deflation occurred in Argentina. The governments tried to prop up the ailing Peso by preventing Argentina to make withdrawals on their banks accounts. By this, it hoped that he bankrupt banking system of Argentina could be saved. This led to chaos and social unrest in Argentina ultimately leading the country to riots .loss to life and property damage.

3.3.2 IMPACT OF DEFLATION ON ECONOMIC GROWTH

The great depression of 1929 was one of the famous examples of deflations in history. In early 1930' s the American economy collapsed due to a variety of reasons which triggered a world-wide depression, in which many people lost their jobs and lack of disposable income in their hands make them to stop buying goods and services . Not only the upper classes cut back on their consumptions of luxury products but also the consumption of working class and middle class people fell drastically. Consequently there was less demand for goods and services in the economy. Producers reduced the prices of their products hoping more people would buy their products, and fired people from employments to compensate for fall in prices. As prices fell the same amount of money could buy more goods and services provided by the appreciation in the real value of money. However, this didn't help those people who lost their jobs due to depression. They didn't have any income to spend on even essential good. Thus beside the general hardship it puts on the people, deflation has significant impact on productions and distribution aspects of the economy.

1. Impact On Production

Deflation is a situation of falling prices, which makes the government bankrupt. The producers and entrepreneurs of commodities face difficulties in finding profitable avenues to invest their funds. Deflationary pressure in economy compels them to unwind their positions, close down productivity operations, and reduce output and employment. Thus, deflation has an adverse impact on production. It is a situation of pessimistic environment where profits fall and force firms to close down their business. This lead to the problem of unemployment in economy. This ultimately reduces the aggregate demand of people. As deflation demoralized people and creates gloomy picture before produces and entrepreneurs regarding future prospects of the economy. It is more dangerous than inflation.

2. Impact of Debt Payers

Deflation, in the first place, adversely affects profits because a fall in prices leads to a fall in sales revenues. Due to fall in prices, the value of money in real terms appreciates and making debts in money more costly. Irving Fisher stressed “past deflation means bankruptcy or near- bankruptcy for leveraged operating companies and nearly all financial institutions “Friedman and Schwartz emphasized the harm caused by deflation on the balance sheet of a bank by reducing the nominal value of collateral and thus, diminishing the debtors, ability to services their debts.

3.4 STAGFLATION- DEFINITION AND MEANING

Stagflation refers to economic condition where economic growth is very slow or stagnant and prices are rising. The term stagflation was coined by British politician Iain Macleod, who used the phrase in his speech to parliament in 1965, when he said: “We now have the worst of both worlds-not just inflation on the one side or stagnation on the other. We have a sort of ‘stagflation’ situation.” The side effects of stagflation are increase in unemployment- accompanied by a rise in prices, or inflation. Stagflation occurs when the economy isn't growing but prices are going up. At international level, this happened during mid 1970s, when world oil prices rose dramatically, fuelling sharp inflation in developed countries.

3.4.1 IMPACT OF STAGFLATION ON ECONOMIC GROWTH

The greatest advantage of stagflation lies in the stability of the real value of the domestic currency. Savings and investments in a stagflationary environment increase. Also, since inflation is low, the nominal value of investment interest is lower, but in terms of real value, these investment interests are similar to those in inflationary environments.

The installments of loans (most notably of mortgage loans) and credits are also easier to meet, as inflation does not devalue the wages and earnings of loan and credit holders. This results in less default loans and credit, which in turn increases the profits of credit institutions.

As during stagflation consumer prices stagnate (hence the name “stagflation”) companies cannot raise their prices. In contrast to a deflationary economy, such companies profits do not shrink, or only by a minimal percentage. These somewhat lower profits can be compensated by improving the cost effectiveness of the company, which doesn’t necessarily mean firing employees.

3.5 SUMMARY

- Inflation is a persistent rise in the general level of prices of goods and services in and economy. When the prices of petrol, diesel and essential commodities like rice, wheat, cooking gas goes up and people need to pay more for the same goods and services then it is inflation. It is situation where too much money chassis too few goods services
- Measures of inflations are Consumers Prices Index, Producers Price Index, Wholesale Price Index, GDP deflator etc.

- Keynes related inflation to a rise in price level which comes into existence after the stage of full employment. He distinguished between two types of price rise:
    - Rise of price of accompanied increase in production and
    - Rise in prices without simultaneous increase in output
- Deflation as a situation where prices essential of services and goods decline over time. This is the opposite of inflation. Deflation generally occurs when the supply of goods rises faster than the supply of money, which is consistent with these four factors.
- There are four basic factors of deflation:
    - Growth Deflation
    - Cash-Building Deflation
    - Bank Credit Deflation
    - Confiscatory Deflation
- When aggregate demand exceeds aggregate supply, there exists an inflationary gap. It refers to a situation where there is excess demand over the available output at existing prices. Deflationary gap is the opposite of the inflationary gap where aggregate supply exceed aggregate demands

3.6 KEYWORDS

Inflation, Deflation, Stagflation, Confiscatory Deflation, Bottlenecks, Wholesale Price Index, Cash Reserve Ratio, Statutory Liquidity Ratio, Artificial Scarcity, Wholesale Price Index, Consumer Price Indexes, Product Price Indexes, Open Inflation, Suppressed Inflation, Creeping Inflation, Hyper Inflation, Disposable Income, Cash Reserve Ratio, Bank Rate, Statutory Liquidity Ratio.

3.7 REVIEW QUESTIONS

1. What do you mean by inflation? Explain its various causes in detail.
2. Define the inflation and explain its various types.
3. What is deflation? Also define the different causes of deflation.
4. Describe the stagflation and its causes.
5. Write a short note on:
    A. Inflation
    B. Deflation
    C. Stagflation

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LESSON-4
MONETARY STANDARDS AND PRESENT CURRENCY SYSTEM OF INDIA

STRUCTURE

4.0 OBJECTIVES

1. In this chapter simply we mean the monetary standard as well as its qualities and how the monetary authority maintained those standard and present currency systems of India.
2. To know about the various type of standard money, forms of monetary standard used in a country also discuss the elementary study of monetary standards.
3. To know, why elementary study of monetary standards is required and how its six principles should be implemented on this monetary standard.

4.1 INTRODUCTION

A monetary standard refers to the set of monetary arrangements and institutions governing the supply of money. It differs from the term “monetary regime” defined as a set of monetary arrangements and institutions accompanied by a set of expectations – expectations by the public with respect to policymaker actions and expectations by policymakers about the public's reaction to their actions. We distinguish two aspects of monetary standards/regimes: domestic and international. The domestic aspect refers to the institutional arrangements and policy actions of monetary authorities. The international aspect relates to monetary arrangements between nations. Two basic types of monetary arrangements prevail: fixed and flexible exchange rates, along with a number of intermediate variants including adjustable pegs and managed floats. Two types of monetary standards/regimes have been present in history, those based on convertibility of all forms of money into currency, generally specie, and those based on fiat. The former prevailed in the world until the 1930s although the Bretton Woods System from 1944-1971 embodied an indirect link to gold; the latter has held sway ever since.

The Specie Standard as a Rule

One of the most important features of the specie standard was that it embodied a monetary rule or commitment mechanism that constrained the actions of the monetary authorities. To the classical economists it was preferable for monetary authorities to follow rules rather than subjecting monetary policy to the discretion of well-meaning officials. Today a rule serves to bind policy actions over time. This view of policy rules, in contrast to the earlier tradition that stressed both impersonality and automaticity, stems form the recent literature on the time inconsistency of optimal government policy.

In terms of the modern perspectives of Kydland and Prescott (1977) and Barro and Gordon (1983), the rule served as a commitment mechanism to prevent governments from setting policies sequentially in a time inconsistent manner. According to this approach, adherence to the fixed price of gold was the commitment that prevented governments from creating surprise fiduciary money issues in order to capture seigniorage revenue, or form defaulting on outstanding debt. On this basis, adherence to the specie standard rule before 1914 enabled many countries to avoid the problems of high inflation and stagflation that troubled the late twentieth century.

The monetary authority maintained the standard- kept the price of the currency in terms of specie fixed – except in the event of a well understood emergency such as a major war. In wartime it might suspend specie convertibility and issue paper money to finance its expenditures, and it could sell debt issues in terms of the nominal value of its undepreciated paper. The rule was contingent in the sense that the public understood that the suspension would last only for the duration of the wartime emergency plus some period of adjustment, and that afterwards the government would adopt the deflationary policies necessary to resume payments at the original parity.

Observing such a rule would allow the government to smooth its revenue from different sources of finance: taxation, borrowing, and seigniorage. That is, in wartime present taxes on labor effort would reduce output when it was needed most, but relying on future taxes or borrowing would be optimal. At the same time positive collection costs might also make it optimal to use the inflation tax as a substitute for conventional taxes. A temporary suspension of convertibility would then allow the government to use the optimal mix of the three sources of finance.

Although the specie standard rule originally evolved as a domestic commitment mechanism, its enduring fame is as an international rule, namely maintenance of specie convertibility to the established par. Maintenance of a fixed price of gold by its adherents in turn ensured fixed exchange rates. The fixed price of domestic currency in terms of specie served as a nominal anchor under the international monetary system.

According to the game theoretic literature, for an international monetary arrangement to be effective both between countries and within them, a time –consistency credible commitment mechanism is required. Adherence to specie convertibility rule provided such a mechanism.

In addition to the reputation of the domestic specie standard and constitutional provisions which ensured a domestic commitment, adherence to international specie standard rule may have been enforced by other mechanisms. These include: the operation of the rules of the game; the hegemonic power of England; central bank cooperation; and improved access to the international capital markets.

Indeed the key enforcement mechanism of the specie standard rule for peripheral countries was access to capital obtainable from the core countries. Adherence to the gold standard was a signal of good behavior, like the “good housekeeping seal of approval”; it explains why countries that adhered to gold convertibility paid lower interest rates on loans contracted in London than others with less consistent performance.

4.2 DEFINITION AND MEANING

A monetary system is a set of policy tools and institutions through which a government provides money and controls the money supply in an economy.

A monetary unit which is designated by a government to serve as the basis of its currency system and into which other types of money in the country are convertible - compare standard of value.

The value behind the money in a monetary system

- synonym: standard

- more generic: value = the quality (positive or negative) that renders something desirable or valuable
- gold standard = a monetary standard under which the basic unit of currency is defined by a stated quantity of gold.
- silver standard = a monetary standard under which the basic unit of currency is defined by a stated quantity of silver
- bimetallism = a monetary standard under which the basic unit of currency is defined by stated amounts of two metals (usually gold and silver) with values set at a predetermined ratio

❖ Qualities of Good Monetary Standard

A sound monetary standard or system should possess the following qualities.

1. Simplicity:

The monetary system should be simple and easily understandable. A simple monetary system inspires public confidence.

2. Elasticity:

A good monetary system should be elastic. It should be capable of changing the money supply according to the requirements of the economy.

3. Economical:

The monetary system should be economical. It should not require heavy expenditure on its operation. An expensive monetary system is a burden on the country. In this regard, paper money is better than the metallic money.

4. Stability:

A good monetary system should ensure internal price stability and external exchange rate stability. Stable internal price level is necessary for the economic growth of the country and stability in the foreign exchange rates is essential for the development of foreign trade.

5. Convertibility:

A sound monetary system must possess the quality of convertibility of the currency into some expensive metal convertible currency system serves to inspire public confidence and facilitate international payments.

6. Legality:

A good monetary system must possess legal sanction; it must be backed by the force of law. Legal tender money increases public confidence and ensures general acceptability.

7. Automatic Working:

A good monetary system should have built- in-flexibility. It should be capable of operating automatically without the government intervention. According to Prof. Caiman, gold standard was, "a fool-proof and knave-proof standard". There was no scope for artificial change in gold standard.

8. Economic Development:

An ideal monetary system must be helpful for a country to achieve the objectives of economic development and maximization of employment.

9. Other Qualities:

A monetary standard should also possess some other qualities like transferability, portability, cognoscibility, uniformity, divisibility, etc.

- **Types of monetary standards**

There are two types of monetary standards, one far more prevalent in developed economies than other. Monetary standards refer to the ‘system’ or ‘framework’ that controls or facilitates the movement of money.

The two monetary standards are:

i. Commodity Standard

ii. Inconvertible ‘managed’ paper standard or Non-Commodity Standard or Fiat Standard

i. Commodity Standard

This standard exists where the value of monetary units equal the value of specific amounts of commodity (for example gold).

Example of commodity standards:

- Monometallic/metallic coin standards
- Metallic exchange standard
- Bimetallic standard

There are some pros and more cons. There are evidently problems with these standards since we have discarded them as the monetary standard of choice. One inherent problem for the bimetallic standard is described in **Gresham’s Law.**

On one hand it does restrain the government from excessively expanding the money supply because monetary standard is driven by physical availability of metal not political experience. However, metal reserves may expand excessively, or conversely contract when the economy needs liquidity to grow.

Pros also include the intrinsic value of silver and gold. Cost of producing metals is inversely related to general level of prices (it provides stability to economic output and prices), however, the process may be too slow.

ii. Inconvertible 'managed' paper standard or Non-Commodity Standard or Fiat Standard

This monetary standard the 'creature of the state' created by the government exists. (Another term is 'fiat' money –> legal tender). This system only works because the government values the legal tender and the public accepts the standard. The public has to accept the standard since the paper itself isn't actually worth anything–it's an abstraction. It fails when the government does not exhibit proper economic restraint and responsibility (i.e. massive hyperinflation).

4.3 FORMS OF MONETARY STANDARD:

There are three main forms of monetary standards. These are:

- **4.3.1 Monometallism or Single Standard**
- **4.3.2 Bimetallism or Double Standard**
- **4.3.3 Paper Currency Standard (Managed Currency Standard)**

4.3.1 Monometallism or Single Standard

When only on metal is adopted as the standard money and is made legal tender for all payments, the system is known as monometallism or single standard. For example, now many countries have the Gold Standard. Suppose a country has adopted silver as the standard money, then it is said to have Silver Standard. For example, England was on Silver Standard until 1816.

4.3.2 Bimetallism or Double Standard

If two metals are adopted as standard money and if a legal ratio is established between the value of the two metals, then the system known as bimetallism or double standard. In other words, under this system, gold and silver circulated as legal tender money and there was a legally fixed ratio of exchange between them. Usually, two metals used under bimetallism are gold and silver. Bimetallism was adopted in France in 1803. Later on, it was adopted by other countries like Belgium, Switzerland and Holland. Bimetallism has certain advantages and disadvantages.

Advantages

1. It would secure greater stability of prices. It there is monometallism, the supply of only one metal could not satisfy the monetary demand satisfactorily. The increasing demand for money should be accompanied by an increase in the supply of money. Otherwise, there cannot be a stable price level. Therefore, if there is bimetallism, the supply of two metals put together will be steadier than that of any one of them. Just as two drunkards might walk more steadily when they walk hand in hand, the supply of two metals under bimetallism will make price level more stable.
2. Bimetallism would promote stable exchange rates between countries using gold and countries using silver.
3. The supply of gold would not be sufficient for the currency requirements if all countries adopted gold standard, that is, if they adopted universal monometallism.
4. Bimetallism will keep world prices stable.

Disadvantages

- There is a great difficulty in maintaining the mint ratio (legal ratio) between the two metals because market ratio will often fluctuate.
- Gresham’s law that bad money drives out good money will operate.
- Bimetallism cannot work if only one country adopted it. All countries in the world should adopt it.

- It may result in a lot of confusion, particularly, if there are differences between the legal ratio and market ratio of the two metals. So bimetallism may not remedy the defects of gold standard; it may increase the difficulties.

4.3.3 Paper Currency Standard (Managed Currency Standard)

Under the system, as the name indicates, the currency of the country will be in paper. Paper money consists of bank notes and government notes. Generally, under the system, the currency system will be managed by the Central Bank of the country. Hence, the system sometimes is referred to as managed paper currency standard. Almost all countries in the world have managed currency standard. The paper currency has certain advantages and disadvantages.

Advantages of Paper Money

Paper money is economical. Its cost of production is negligible. It is convenient to handle and it is easily portable. It is homogeneous. Its supply can be made elastic. And its value can be kept stable by proper management. Paper currency can function very effectively as money, provided, there is proper control of it by the managing authority. It is ideal for internal trade. But for international trade and payments, gold is still found necessary.

Disadvantages of Paper Money

There is the danger of over-issue of paper money by the managing authorities. Over-issue of currency will result in a rise in prices, adverse foreign exchange rates and many other evils. The over-issue of paper money has ruined many countries in the past. Another disadvantage of paper money is that it will not have universal acceptance. It is recognized as money only in the country where it is issued. For others, paper money is just bits of paper. Gold, on the other hand, has universal acceptance.

4.4 ELEMENTARY STUDY OF MONETARY STANDARDS

The Monetary Standard of the Future Concerning the world's monetary standard of the future, the logical conclusion to be drawn from the preceding discussion may well be summarized·· in the following excerpt from the 1931 report of the Macmillan Committee, which consisted of 14 eminent British financiers and economists:

There is, perhaps, no more important object in the field of human technique than that the world as a whole should achieve a sound and scientific monetary system. But there can be little or no hope of progress at an early date for the monetary system of the world as a whole, except as the result of a process of evolution starting from the historic gold standard. With what sort of a gold standard should the world begin its postwar monetary economy? That is a large question, and all that we may hope to do by way of giving it an answer within the limits of one chapter of a small book is to state briefly a few general principles.

- **Preliminaries**

By way of preliminaries, six principles should be followed. They are:

1. The subject is an international one, and its satisfactory solution demands' a high degree of international cooperation, which should begin at once and continue indefinitely. It should include small nations as well as large ones. There is no place for stabilization competition such as the world experienced after the First World War, when a number of countries resorted to monetary-unit undervaluation, in the effort to improve their competitive position vis-à-vis other countries in the export trade.

2. The monetary unit should be established in each country after conference with other countries, but without any compulsion whatever from them. The determination of the size of a nation's monetary unit is affected with such a great public interest and so highly prized as a prerogative of sovereignty that it is impracticable to subject it to outside interference. The new unit

should be approximately the value of the monetary unit in operation at the time the stabilization is effected, or some easy multiple of that unit.

3. Inflationary policies should be discontinued at the earliest possible date after the armistice and everything possible should be done by the government to inspire confidence in the currency.

4. Measures providing for the ultimate discontinuance of all artificial price and exchange controls should be taken early, but the process of discontinuing them should be put into effect by cautiously measured steps.

5. After prices have settled down to what, for want of a better name, may be called their *natural level,* there should be a tryout *de facto* stabilization of the monetary unit at this level.

6 . The *de facto* stabilization in due time should be followed by a *de jure* stabilization,- but the latter should not be adopted until the government is in a strong enough position financially to be confident that it can make such a stabilization stick.

- **Types of postwar gold standard**

As has been previously noted, there are three important types of gold standard, *viz.,* the gold-coin standard, the gold-bullion standard, and the gold exchange standard. These types frequently overlap and each of them is found in many varieties. Each type has its own advantages and disadvantages, and these are relative to the economic, fiscal, and political conditions in the different countries. One type is best adapted to one country and another type to another country. The gold-coin standard is the strongest type domestically and puts up the best defenses against disturbances from abroad. On the other hand, it provides gold coin for internal circulation and makes it easily accessible to hoarders; the gold-coin standard is the most expensive type in the amount of gold it requires. The gold exchange standard, on the other hand, while requiring gold or gold credit only for exchange purposes at the limits marked by the gold points, and while keeping this gold abroad, normally for the most part in the form of bank deposits, is the least expensive. The gold-bullion standard provides no gold for internal circulation and makes it difficult to obtain gold for hoarding. Its reserves, however, are held in the form of gold bullion. Therefore, although requiring less gold than the gold-coin standard, the gold-bullion standard requires much more than does the gold exchange standard. Consequently, it takes an intermediate position. In general, the richest nations would probably choose the gold-coin standard, while the poorest nations, as well as colonies and other dependencies, would prefer the gold-exchange standard. Countries in an intermediate position would prefer the gold-bullion standard. The shifting from one type of gold standard to another might be used as an instrument of international monetary policy directed toward the stabilizing of the value of gold. If, for example, a situation should develop in which gold production was falling off and the world's supply of monetary gold was lagging behind the world's demand, it would be desirable to economize the use of gold. This would dictate shifts from the gold-coin standard to the gold bullion and gold-exchange standards. If, on the other hand, gold production should increase unduly, with a resulting tendency to gold inflation, there could be shifts in the opposite direction-i.e., toward the gold coin standard-so as to increase the demand for gold.

- **Implementation of international gold standard**

All monetary standards in modern times are more or less managed. It is not a question of the presence or the absence of monetary management, but rather of the extent and character of that management. With the gold standard, the management that will be required should be imposed upon a monetary system that is fundamentally automatic in its functioning and should be conducted according to certain 'established principles that will be accepted by the world's leading central banks under the authority of their respective governments. With reference to this management or non management, the following general principles should be followed.

There should be no restrictions on the holding by the public of gold coin or gold bullion within the country or on the free coinage of bullion at the mints or the melting down of gold coin. The exportation and importation of gold should be free from all trade restrictions and tariffs. Under such conditions, gold will enjoy a very high degree of fluidity in its movements both national and international, and the value of the gold monetary unit in each gold-standard country will be held very close to that of its gold equivalent in every other gold-standard country and to the value of gold bullion in the free markets of the world. There should be a high degree of freedom in the international movement of goods and services. The gold standard can function over high tariff barriers, as it has many times in the past, but high tariff barriers are obstacles to international .trade and finance and to the smooth and orderly functioning of any monetary standard. On this subject there has been much confusion growing out of the popular notion that gold moves in international trade only "to pay balances." As a matter of fact, gold moves for the same fundamental reason that any other commodity moves to seek the best market. It goes abroad whenever it is worth abroad more than it is worth at home, by a sufficient margin to yield an attractive profit after paying all the expenses of its exportation. Its importation from abroad is merely the other side of the same shield. As a general proposition, omitting such things as gifts and losses by shipwreck, bankruptcy, fraud, and theft, a nation's total exports-visible and invisible are equal to its total imports-visible and invisible when viewed over a substantial period of time. If this were not true, a nation would either be getting goods from abroad free or giving away goods to foreigners. If, for example, a country is normally exporting 50 different commodities and services (including gold, from time to time) and is normally importing 60 different commodities and services (including gold, from time to time), the 50' commodities on the one side and the 60 on the other will be in balance. The balance will be destroyed if *any* commodity on either side is omitted and this is no more true of the commodity gold than of any other commodity in the balance sheet. Gold normally moves very easily in international trade, because it is the most marketable of all commodities. It does not move "to pay a balance," in any true sense of that term. A country that has sold goods in a foreign market has a credit there that it can draw upon for the purchase of any goods for, sale in that market at the current market price and this applies as fully to gold as to any other commodity. Viscount Goschen once said, in speaking of England's .position, "Our powers of obtaining gold would only be exhausted \when the country had nothing left to sell." Henry Thornton, at the time of the famous Bullion Controversy in England early in the last century, said concerning the place of specie in international trade.

4.5 SUMMARY

A monetary standard refers to the set of monetary arrangements and institutions governing the supply of money. Two types of monetary standards/regimes have been present in history, those based on convertibility of all forms of money into currency, generally specie, and those based on fiat. According to the game theoretic literature, for an international monetary arrangement to be effective both between countries and within them, a time –consistency credible commitment mechanism is required.

- **Qualities of Good Monetary Standard**
    - Simplicity
    - Elasticity
    - Economical
    - Stability

- Convertibility
- Legality
- Automatic Working:
- Economic Development:
- Other Qualities:

- **Types of monetary standards**
    - Commodity Standard or Metallic Standard
    - Inconvertible 'managed' paper standard or Non-Commodity Standard or Fiat Standard
- **Elementary study of monetary standards**
    - Preliminaries
    - Types of postwar gold standard
    - Implementation of international gold standard

4.6 KEYWORDS

Monetary Standard, Synonym Standard, Gold Standard, Silver Standard, Bimetallism, Monometallism Standard, Paper Currency Standard, Flexible Exchange Rates, Fiduciary Money, Seigniorage Revenue, External Exchange Rate, Legal Tender Money.

4.7 REVIEW QUESTION

1. What do you mean by monetary standard?
2. Define the monetary standard and explain its various types.
3. Describe the elementary study of monetary standard.
4. Write a short note on:
    - Gold standard
    - Preliminaries

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LESSON-5
BANK: MEANING AND FUNCTIONS

STRUCTURE

5.0 OBJECTIVES

In this context, basic purpose to know about the term ‘bank’ and it’s various functions. In ordinary sense, the term ‘bank’ refers to an establishment which trades in money. It borrows money from the public at lower rates of interest.

1. To study about the various types of banks which perform function in various areas? In a developing country like India, how the banking sector has played a multi-dimensional and multi-directional role in overall development of the country.
2. To study the recent trends in Indian Banking and how Information Technology (IT) and Customer Satisfaction Management(CRM) play a vital role in banking.
3. To learn about the policy of credit creation and its various methods by which banks produced their revenue.

5.1 INTRODUCTION

A bank is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly by loaning or indirectly through capital markets. A bank is the connection between customers that have capital deficits and customers with capital surpluses. Due to their influence within a financial system and the economy, banks are highly regulated in most countries. Most banks operate under a system known as fractional reserve banking where they hold only a small reserve of the funds deposited and lend out the rest for profit. They are generally subject to minimum capital requirements which are based on an international set of capital standards, known as the Basel Accords. Banking in its modern sense evolved in the 14th century in the rich cities of Renaissance Italy but in many ways was a continuation of ideas and concepts of credit and lending that had its roots in the ancient world. In the history of banking, a number of banking dynasties have played a central role over many centuries.

Banks offer many different channels to access their banking and other services:

- Automated Teller Machines
- A branch is a retail location
- Call center
- Mail: most banks accept cheque deposits via mail and use mail to communicate to their customers, e.g. by sending out statements
- Mobile banking is a method of using one's mobile phone to conduct banking transactions
- Online banking is a term used for performing multiple transactions, payments etc. over the Internet
- Relationship Managers, mostly for private banking or business banking, often visiting customers at their homes or businesses

- Telephone banking is a service which allows its customers to perform transactions over the telephone with automated attendant or when requested with telephone operator
- Video banking is a term used for performing banking transactions or professional banking consultations via a remote video and audio connection. Video banking can be performed via purpose built banking transaction machines (similar to an Automated teller machine), or via a video conference enabled bank branch clarification

5.2 DEFINITIONS AND MEANING

Under English common law, a banker is defined as a person who carries on the business of banking, which is specified as:

- conducting current accounts for his customers,
- paying cheques drawn on him/her, and
- Collecting cheques for his/her customers.

"Banking business" means the business of either or both of the following:

1. receiving from the general public money on current, deposit, savings or other similar account repayable on demand or within less than [3 months] ... or with a period of call or notice of less than that period;
2. paying or collecting checks drawn by or paid in by customers

Banks in economy

The economic functions of banks include:

1. Issue of money, in the form of banknotes and current accounts subject to check or payment at the customer's order. These claims on banks can act as money because they are negotiable or repayable on demand, and hence valued at par. They are effectively transferable by mere delivery, in the case of banknotes, or by drawing a check that the payee may bank or cash.

2. Netting and settlement of payments – banks act as both collection and paying agents for customers, participating in interbank clearing and settlement systems to collect, present, be presented with, and pay payment instruments. This enables banks to economize on reserves held for settlement of payments, since inward and outward payments offset each other. It also enables the offsetting of payment flows between geographical areas, reducing the cost of settlement between them.

3. Credit quality improvement–banks lend money to ordinary commercial and personal borrowers (ordinary credit quality), but are high quality borrowers. The improvement comes from diversification of the bank's assets and capital which provides a buffer to absorb losses without defaulting on its obligations. However, banknotes and deposits are generally unsecured; if the bank gets into difficulty and pledges assets as security, to raise the funding it needs to continue to operate, this puts the note holders and depositors in an economically subordinated position.

4. Asset liability mismatch/Maturity transformation – banks borrow more on demand debt and short term debt, but provide more long term loans. In other words, they borrow short and lend long. With a stronger credit quality than most other borrowers, banks can do this by aggregating issues (e.g. accepting deposits and issuing banknotes) and redemptions (e.g. withdrawals and redemption of banknotes), maintaining reserves of cash, investing in marketable securities that can be readily converted to cash if needed, and raising replacement funding as needed from various sources (e.g. wholesale cash markets and securities markets).

5. Money creation – whenever a bank gives out a loan in a fractional-reserve banking system, a new sum of virtual money is created.

Characteristics / Features of a Bank

1. Dealing in Money: - Bank is a financial institution which deals with other people's money i.e. money given by depositors. The banks accept deposits from the public and advancing them as loans to the needy people. The deposits may be of different type's current, fixed, savings, etc. accounts. The deposits are accepted on various terms and conditions.

2. Individual / Firm / Company:-A bank may be a person, firm or a company. A banking company means a company which is in the business of banking.

3. Acceptance of Deposit:-A bank accepts money from the people in the form of deposits which are usually repayable on demand or after the expiry of a fixed period. It gives safety to the deposits of its customers. It also acts as a custodian of funds of its customers.

4. Payment and Withdrawal:-A bank provides easy payment and withdrawal facility to its customers in the form of cheques and drafts. It also brings bank money in circulation. This money is in the form of cheques, drafts, etc.

5. Agency and Utility Services:-A bank provides various banking facilities to its customers. They include general utility services and agency services.

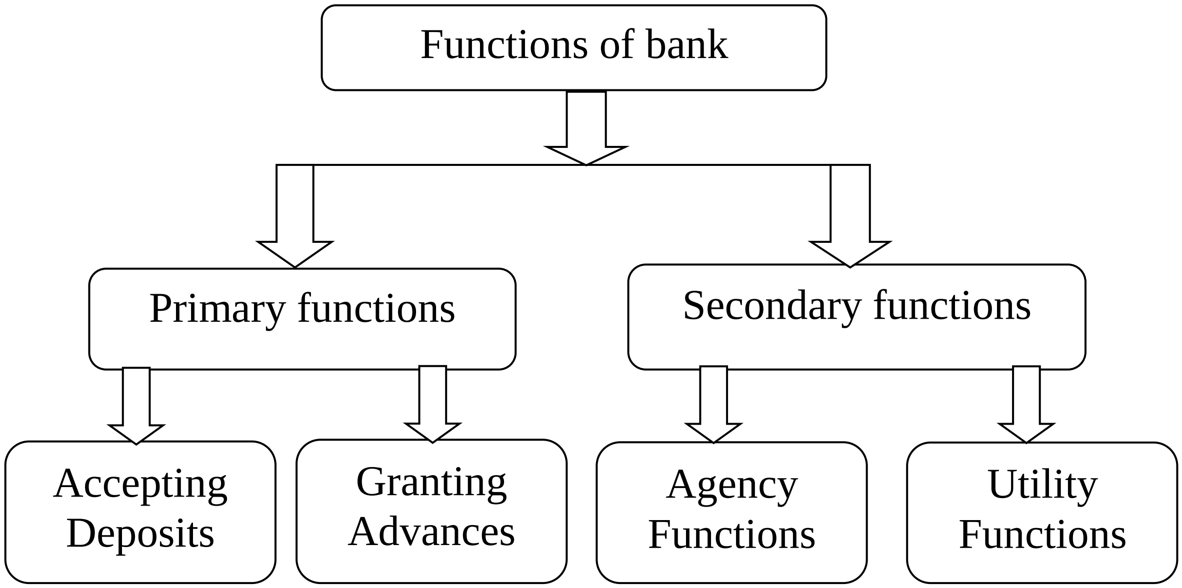
6. Ever increasing Functions:-Banking is an evolutionary concept. There is continuous expansion and diversification as regards the functions, services and activities of a bank.

7. Connecting Link:-A bank acts as a connecting link between borrowers and lenders of money. Banks collect money from those who have surplus money and give the same to those who are in need of money.

8. Banking Business:-A bank's main activity should be to do business of banking which should not be subsidiary to any other business.

9. Name Identity:-A bank should always add the word "bank" to its name to enable people to know that it is a bank and that it is dealing in money.

5.3 FUNCTIONS OF BANK



Saving Deposits Overdraft Transfer of Funds Drafts

Fixed Deposits Cash Credit Collection of Cheques Lockers

Current Deposits Loans Periodic Payments Underwriting

Recurring Deposits Discounting of Bills Portfolio Management

Project Reports

Periodic Collections Social Welfare

Programmes

Other Agency Functions Other Utility

Functions

Primary functions

The primary functions of a bank are also known as banking functions. These are the main functions of a bank.

These primary functions of banks are explained below.

1. Accepting Deposits

The bank collects deposits from the public. These deposits can be of different types, such as:-

a. Saving Deposits
b. Fixed Deposits
c. Current Deposits
d. Recurring Deposits

a. Saving Deposits:-This type of deposits encourages saving habit among the public. The rate of interest is low. At present it is about 5% p.a. Withdrawals of deposits are allowed subject to certain restrictions. This account is suitable to salary and wage earners. This account can be opened in single name or in joint names.

b. Fixed Deposits:-Lump sum amount is deposited at one time for a specific period. Higher rate of interest is paid, which varies with the period of deposit. Withdrawals are not allowed before the expiry of the period. Those who have surplus funds go for fixed deposit.

c. Current Deposits:-This type of account is operated by businessmen. Withdrawals are freely allowed. No interest is paid. In fact, there are service charges. The account holders can get the benefit of overdraft facility.

d. Recurring Deposits:-This type of account is operated by salaried persons and petty traders. A certain sum of money is periodically deposited into the bank. Withdrawals are permitted only after the expiry of certain period. A higher rate of interest is paid.

2. Granting of Loans and Advances

The bank advances loans to the business community and other members of the public. The rate charged is higher than what it pays on deposits. The difference in the interest rates (lending rate and the deposit rate) is its profit.

The types of bank loans and advances are:-

a. Overdraft
b. Cash Credits
c. Loans
d. Discounting of Bill of Exchange

a. Overdraft:-These types of advances are given to current account holders. No separate account is maintained. All entries are made in the current account. A certain amount is sanctioned as overdrafts which can be withdrawn within a certain period of time say three months or so. Interest is charged on actual amount withdrawn. An overdraft facility is granted against a collateral security. It is sanctioned to businessman and firms.

b. Cash Credits:-The client is allowed cash credit up to a specific limit fixed in advance. It can be given to current account holders as well as to others who do not have an account with bank. Separate cash credit account is maintained. Interest is charged on the amount withdrawn in excess of limit. The cash credit is given against the security of tangible assets and / or guarantees. The advance is given for a longer period and a larger amount of loan is sanctioned than that of overdraft.

c. Loans:-It is normally for short term say a period of one year or medium term say a period of five years. Now-a-days, banks do lend money for long term. Repayment of money can be in the form of installments spread over a period of time or in a lump sum amount. Interest is charged on the actual amount sanctioned, whether withdrawn or not. The rate of interest may be slightly lower than what is charged on overdrafts and cash credits. Loans are normally secured against tangible assets of the company.

d. Discounting of Bill of Exchange:-The bank can advance money by discounting or by purchasing bills of exchange both domestic and foreign bills. The bank pays the bill amount to the drawer or the beneficiary of the bill by deducting usual discount charges. On maturity, the bill is presented to the drawee or acceptor of the bill and the amount is collected.

Secondary Functions

The bank performs a number of secondary functions, also called as nonbanking functions. These important secondary functions of banks are explained below.

1. Agency Functions

The bank acts as an agent of its customers. The bank performs a number of agency functions which includes:-

a. Transfer of Funds
b. Collection of Cheques
c. Periodic Payments
d. Portfolio Management
e. Periodic Collections
f. Other Agency Functions

a. Transfer of Funds:-The bank transfer funds from one branch to another or from one place to another.

b. Collection of Cheques:-The bank collects the money of the cheques through clearing section of its customers. The bank also collects money of the bills of exchange.

c. Periodic Payments:-On standing instructions of the client, the bank makes periodic payments in respect of electricity bills, rent, etc.

d. Portfolio Management:-The banks also undertake to purchase and sell the shares and debentures on behalf of the clients and accordingly debits or credits the account. This facility is called portfolio management.

e. Periodic Collections:-The bank collects salary, pension, dividend and such other periodic collections on behalf of the client.

f. Other Agency Functions:-They act as trustees, executors, advisers and administrators on behalf of its clients. They act as representatives of clients to deal with other banks and institutions.

2. General Utility Functions

The bank also performs general utility functions, such as :-

a. Issue of Drafts, Letter of Credits, etc.
b. Locker Facility
c. Underwriting of Shares
d. Dealing in Foreign Exchange
e. Project Reports
f. Social Welfare Programmes
g. Other Utility **Functions**

a. Issue of Drafts and Letter of Credits:-Banks issue drafts for transferring money from one place to another. It also issues letter of credit, especially in case of, import trade. It also issues travelers' cheques.

b. Locker Facility:-The bank provides a locker facility for the safe custody of valuable documents, gold ornaments and other valuables.

c. Underwriting of Shares:-The bank underwrites shares and debentures through its merchant banking division.

d. **Dealing in Foreign Exchange:-**The commercial banks are allowed by RBI to deal in foreign exchange.

e. **Project Reports:-**The bank may also undertake to prepare project reports on behalf of its clients.

f. **Social Welfare Programmes:-**It undertakes social welfare programmes, such as adult literacy programmes, public welfare campaigns, etc.

g. **Other Utility Functions:-**It acts as a referee to financial standing of customers. It collects creditworthiness information about clients of its customers. It provides market information to its customers, etc. It provides travelers cheque facility.

5.4 TYPES OF BANKS

1. Saving Banks

Saving banks are established to create saving habit among the people. These banks are helpful for salaried people and low income groups. The deposits collected from customers are invested in bonds, securities, etc. At present most of the commercial banks carry the functions of savings banks. Postal department also performs the functions of saving bank.

2. Commercial Banks

Commercial banks are established with an objective to help businessmen. These banks collect money from general public and give short-term loans to businessmen by way of cash credits, overdrafts, etc. Commercial banks provide various services like collecting cheques, bill of exchange, and remittance money from one place to another place. In India, commercial banks are established under Companies Act, 1956. In 1969, 14 commercial banks were nationalized by Government of India. The policies regarding deposits, loans, rate of interest, etc. of these banks are controlled by the Central Bank.

3. Industrial Banks / Development Banks

Industrial / Development banks collect cash by issuing shares & debentures and providing long-term loans to industries. The main objective of these banks is to provide long-term loans for expansion and modernization of industries. In India such banks are established on a large scale after independence. They are Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI) and Industrial Development Bank of India (IDBI).

4. Land Mortgage / Land Development Banks

Land Mortgage or Land Development banks are also known as *Agricultural Banks* because these are formed to finance agricultural sector. They also help in land development. In India, Government has come forward to assist these banks. The Government has guaranteed the debentures issued by such banks. There is a great risk involved in the financing of agriculture and generally commercial banks do not take much interest in financing agricultural sector.

5. Indigenous Banks

Indigenous banks mean *Money Lenders* and *Sahukars*. They collect deposits from general public and grant loans to the needy persons out of their own funds as well as from deposits. These indigenous banks are popular in villages and small towns. They perform combined functions of trading and banking activities. Certain well-known Indian communities like *Marwaries* and *Multani* even today run specialized indigenous banks.

6. Central / Federal / National Bank

Every country of the world has a central bank. In India, Reserve Bank of India, in U.S.A, Federal Reserve and in U.K, Bank of England. These central banks are the bankers of the other banks.

They provide specialized functions i.e. issue of paper currency, working as bankers of government, supervising and controlling foreign exchange. A central bank is a non-profit making institution. It does not deal with the public but it deals with other banks. The principal responsibility of Central Bank is thorough control on currency of a country.

7. Co-operative Banks

In India, Co-operative banks are registered under the Co-operative Societies Act, 1912. They generally give credit facilities to small farmers, salaried employees, small-scale industries, etc. Co-operative Banks are available in rural as well as in urban areas. The functions of these banks are just similar to commercial banks.

8. Exchange Banks

Hong Kong Bank, Bank of Tokyo, Bank of America are the examples of Foreign Banks working in India. These banks are mainly concerned with financing foreign trade.

Following are the various functions of Exchange Banks:-

- Remitting money from one country to another country,
- Discounting of foreign bills,
- Buying and Selling Gold and Silver, and
- Helping Import and Export Trade.

9. Consumers Banks

Consumers bank is a new addition to the existing type of banks. Such banks are usually found only in advanced countries like U.S.A. and Germany. The main objective of this bank is to give loans to consumers for purchase of the durables like Motor car, television set, washing machine, furniture, etc. The consumers have to repay the loans in easy installments.

5.5 RECENT TRENDS IN INDIAN BANKING

Information Technology in Banking

Indian banking industry, today is mid of an IT revolution. A combination of regulatory and competitive reasons has led to increasing importance of total banking automation in the Indian Banking Industry. The bank which used the right technology to supply timely information will see productivity increase and thereby gain a competitive edge. To compete in an economy which is opening up, it is imperative for the Indian Banks to observe the latest technology and modify it to suit their environment. Information technology offers a chance for banks to build new systems that address a wide range of customer needs including many that may not be imaginable today.

Role of Information Technology (IT) and Customer Relationship Management (CRM) in Banking

IT plays an important role in the banking sector as it would not only ensure smooth passage of inter related transactions over the electric medium but will also facilitate complex financial product innovation and product development. The application of IT and e-banking is becoming the order of the day with the banking system heading towards virtual banking. Banks, who strongly rely on the merits of 'relationship was banking' as a time tested way of targeting & servicing clients, have readily embraced CRM, with sharp focus on customer centricity, facilitated by the availability of superior technology. CRM, therefore, has become a new mantra in service management, both relationship & information wise.

Following are the innovative services offered by the industry in the recent past:

- **Electronic Payment Services - E Cheques**

Nowadays we are hearing about e-governance, e-mail, e-commerce, e-tail etc. In the same manner, a new technology is being developed in US for introduction of e-cheque, which will eventually replace the conventional paper cheque. India, as harbinger to the introduction of e-cheque, the

Negotiable Instruments Act has already been amended to include; Truncated cheque and E-cheque instruments.

- **Real Time Gross Settlement (RTGS)**

  Real Time Gross Settlement system, introduced in India since March 2004, is a system through which electronics instructions can be given by banks to transfer funds from their account to the account of another bank. The RTGS system is maintained and operated by the RBI and provides a means of efficient and faster funds transfer among banks facilitating their financial operations. As the name suggests, funds transfer between banks takes place on a 'Real Time' basis. Therefore, money can reach the beneficiary instantaneously and the beneficiary's bank has the responsibility to credit the beneficiary's account within two hours.

- **Electronic Funds Transfer (EFT)**

  Electronic Funds Transfer (EFT) is a system whereby anyone who wants to make payment to another person/company etc. can approach his bank and make cash payment or give instructions/authorization to transfer funds directly from his own account to the bank account of the receiver/beneficiary. Complete details such as the receiver's name, bank account number, account type (savings or current account), bank name, city, branch name etc. should be furnished to the bank at the time of requesting for such transfers so that the amount reaches the beneficiaries' account correctly and faster. RBI is the service provider of EFT.

- **Electronic Clearing Service (ECS)**

  Electronic Clearing Service is a retail payment system that can be used to make bulk payments/receipts of a similar nature especially where each individual payment is of a repetitive nature and of relatively smaller amount. This facility is meant for companies and government departments to make/receive large volumes of payments rather than for funds transfers by individuals.

- **Automatic Teller Machine (ATM)**

  Automatic Teller Machine is the most popular devise in India, which enables the customers to withdraw their money 24 hours a day 7 days a week. It is a devise that allows customer who has an ATM card to perform routine banking transactions without interacting with a human teller. In addition to cash withdrawal, ATMs can be used for payment of utility bills, funds transfer between accounts, deposit of cheques and cash into accounts, balance enquiry etc.

- **Point of Sale Terminal (POST)**

  Point of Sale Terminal is a computer terminal that is linked online to the computerized customer information files in a bank and magnetically encoded plastic transaction card that identifies the customer to the computer. During a transaction, the customer's account is debited and the retailer's account is credited by the computer for the amount of purchase.

- **Tele Banking (TB)**

  Tele Banking facilitates the customer to do entire non-cash related banking on telephone. Under this devise Automatic Voice Recorder is used for simpler queries and transactions. For complicated queries and transactions, manned phone terminals are used.

- **Electronic Data Interchange (EDI)**

  Electronic Data Interchange is the electronic exchange of business documents like purchase order, invoices, shipping notices, receiving advices etc. in a standard, computer processed, universally accepted format between trading partners. EDI can also be used to transmit financial information and payments in electronic form.

Challenges Faced by Banks, vis-à-vis, IT Implementation

It is becoming increasingly imperative for banks to assess and ascertain the benefits of technology implementation. The fruits of technology will certainly taste a lot sweeter when the returns can be measured in absolute terms but it needs precautions and the safety nets. The increasing use of technology in banks has also brought up 'security' concerns. To avoid any mishaps on this account, banks ought to have in place a well-documented security policy including network security and internal security. The passing of the Information Technology Act has come as a boon to the banking sector, and banks should now ensure to abide strictly by its covenants. An effort should also be made to cover e-business in the country's consumer laws. Some are investing in it to drive the business growth, while others are having no option but to invest, to stay in business. The choice of right channel, justification of IT investment on ROI, e-governance, customer relationship management, security concerns, technological obsolescence, mergers and acquisitions, penetration of IT in rural areas, and outsourcing of IT operations are the major challenges and issues in the use of IT in banking operations.

5.6 CREDIT CREATION

The creation of credit or deposits is one of the most vital operations of the commercial banks. Similar to other corporations, banks aim at earnings profits. For this intention, they accept cash in demand deposits and advance loans on credit to customers. When a bank advances funds, it does not pay the amount in currency notes. However, it introduces a current account in the name of the investor and lets him to withdraw the necessary amount by cheques. By this way, banks create deposits or credit.

Demand deposits mount in two ways:

1. When the customer deposits currency with commercial banks, and

2. When banks advance loans, discount bills, provide overdraft facilities and make deposit investments through bonds and securities.

The first type of demand deposits is termed “primary deposits”. Banks play a passive play in introducing them. The second type of demand deposits is termed as “derivative deposits”. Banks actively create deposits.

As per Withers, Banks can generate credit by introducing a deposit, every time they advance a loan.

1. This is for the reason that every time a loan is sanctioned, imbursement is made through cheques by the customers.
2. All such imbursements are regulated through the clearing house.
3. As long as the loan is due, a deposit of that amount remains pending in the books of the bank.
4. Thus every loan creates a deposit; however, this is an overstated and tremendous outlook.

Credit creation is one of the important functions of a commercial bank. It constitutes the major component of money supply in the economy commercial banks differs from other financial institutions in this aspect. Other financial institutions transfer money from the lenders to the borrowers. Commercial banks while performing the same function, they create credit or bank money also. Professor Sayers says, "Banks are not merely purveyors of money, but in an important sense, they are the manufacturers of money".

The process of credit creation occurs when banks accepts deposits and provide loans and advances. When the customer deposits money with the bank, they are called primary deposits. This money will not be withdrawn immediately by them. Hence banks keeps a certain amount of deposits as reserves which is known as cash reserve ratio and provide the balance amount as loans and advances. Thus, every deposit creates a loan. Commercial banks give loans and advances against some security to the public. But the bank does not give the loan amount directly. It opens an account in the name of the borrower and deposits the amount in that account. Thus, every loan creates a deposit. The loan amount can be withdrawn by means of cheques. They create a deposit while lending money also. Customers use these loans to make payments. While paying they issue a checks against these deposits. The person who receives the cheques, deposit it in another bank. For that bank, this will be the primary deposit. A part of the deposit will be kept as a reserve and the balance will be used for giving loans and advances. This process is repeated by other banks. When all the banks involve in this process, it is called **Multiple Credit Creation.**

Assumption

The concept of credit creation is based on the following assumptions: Assumptions of Credit Creation

1. The banks, while granting loans, do not give the amount in cash, instead it credits the accounts of the customers with the amount of loan.
2. The customers do not withdraw the entire amount of loan.
3. While drawing the money from his account he uses cheque system.
4. The persons who are receiving the cheques against their claims from others also deposit the money into their respective banks.
5. The accounts are settled with mere book entries.

5.7 METHODS OF CREDIT CREATION

The methods of credit creation in the bank are bank deposits. The bank deposits are of two kinds' viz., (1) Primary deposits, and (2) Derivative deposits.

1. **Primary Deposits:** Primary deposits arise or formed when cash or cheque is deposited by customers. When a person deposits money or cheque, the bank will credit his account. The customer is free to withdraw the amount whenever he wants by cheques. These deposits are called

“primary deposits” or “cash deposits.” It is out of these primary deposits that the bank makes loans and advances to its customers. The initiative is taken by the customers themselves. In this case, the role of the bank is passive. So these deposits are also called “passive deposits.” These deposits merely convert currency money into deposit money. They do not create money. They do not make any net addition to the stock of money. In other words, there is no increase in the supply of money.

2. **Derivative Deposits:** Bank deposits also arise when a loan is granted or when a bank discounts a bill or purchase government securities. Deposits which arise on account of granting loan or purchase of assets by a bank are called “derivative deposits.” Since the bank play an active role in the creation of such deposits, they are also known as “active deposits.” When the banker sanctions a loan to a customer, a deposit account is opened in the name of the customer and the sum is credited to his account. The bank does not pay him cash. The customer is free to withdraw the amount whenever he wants by cheques. Thus the banker lends money in the form of deposit credit. The creation of a derivative deposit does result in a net increase in the total supply of money in the economy; Hartly Withers says “every loan creates a deposit.” It may also be said “loans make deposits” or “loans create deposits.” It is rightly said that “deposits are the children of loans, and credit is the creation of bank clerk’s pen.”

Granting a loan is not the only method of creating deposit or credit. Deposits also arise when a bank discounts a bill or purchase government securities. When the bank buys government securities, it does not pay the purchase price at once in cash. It simply credits the account of the government with the purchase price. The government is free to withdraw the amount whenever it wants by cheque. Similarly, when a bank purchase a bill of exchange or discounts a bill of exchange, the proceeds of the bill of exchange is credited to the account of the seller and promises to pay the amount whenever he wants. Thus asset acquired by a bank creates an equivalent bank deposit. It is perfectly correct to state that “bank loans create deposits.” The derivate deposits are regarded as bank money or credit. Thus the power of commercial banks to expand deposits through loans, advances and investments is known as “credit creation.”

Thus, credit creation implies multiplication of bank deposits. Credit creation may be defined as “the expansion of bank deposits through the process of more loans and advances and investments.”

Limitations:

- Credit creation depends upon the amount of deposits.
- There exists an inverse relation between credit creation and cash reserve ratio. During inflation the CRR will be high to reduce credit.
- Banking habits of the people are well developed; it will lead to expansion of credit.
- Loans are sanctioned by banks against some security. If enough securities are available, then credit creation will be more and vice versa.
- If the entire commercial banks, follows a uniform policy regarding CRR, this credit creation would be smooth.
- If the liquidity preference of the people is high, the credit creation will be less and vice versa.
- If business conditions are bright then demand for credit will be more.
- Customers should be willing to borrow from the banks to facilitate credit creation.
- Credit control policy of the Central Bank, for example during the depression, the RBI encourages the commercial banks to expand credit.

The commercial banks do not have unlimited power of credit creation. Their power to create credit is limited by the following factors:

a. **Amount of Cash:** The power to create credit depends on the cash received by banks. If banks receive more cash, they can create more credit. If they receive less cash they can create less credit. Cash supply is controlled by the central bank of the country.

b. **Cash Reserve Ratio:** All deposits cannot be used for credit creation. Banks must keep certain percentage of deposits in cash as reserve. The volume of bank credit depends also on the cash reserve ratio the banks have to keep. If the cash reserve ratio is increased, the volume of credit that the banks can create will fall. If the cash reserve ratio is lowered, the bank credit will increase. The Central Bank has the power to prescribe and change the cash reserve ratio to be kept by the commercial banks. Thus the central bank can change the volume of credit by changing the cash reserve ratio.

c. **Banking Habits of the People:** The loan advanced to a customer should again come back into banks as primary deposit. Then only there can be multiple expansions. This will happen only when the banking habit among the people is well developed. They should keep their money in the banks as deposits and use cheques for the settlement of transactions.

d. **Nature of Business Conditions in the Economy:** Credit creation will depend upon the nature of business conditions. Credit creation will be large during a period of prosperity, while it will be smaller during a depression. During periods of prosperity, there will be more demand for loans and advances for investment purposes. Many people approach banks for loans and advances. Hence, the volume of bank credit will be high. During periods of business depression, the amount of loans and advances will be small because businessmen and industrialists may not come to borrow. Hence the volume of bank credit will be low.

e. **Leakages in Credit-Creation:** There may be some leakages in the process of credit creation. The funds may not flow smoothly from one bank to another. Some people may keep a portion of their amount as idle cash.

f. **Sound Securities:** A bank creates credit in the process of acquiring sound and profitable assets, like bills, and government securities. If people cannot offer sound securities, a bank cannot create credit. Crowther says "a bank cannot create money out of thin air. It transmutes other forms of wealth into money."

g. **Liquidity Preference:** If people desire to hold more cash, the power of banks to create credit is reduced.

h. **Monetary Policy of the Central Bank:** The extent of credit creation will largely depend upon the monetary policy of the Central Bank of the country. The Central Bank has the power to influence the volume of money in circulation and through this it can influence the volume of credit created by the banks. The Central Bank has also certain powerful weapons, like the bank rate, open market operations with the help of which it can exercise control on the expansion and contraction of credit by the commercial bank.

Thus, the ability of the bank to create credit is subject to various limitations. Still, one should not undermine the importance of the function of credit creation of the banks. This function has far-reaching effect on the working of the economy, especially on the business activity. Bank credit is the oil which lubricates the wheels of the business machine.

Process of Credit Creation

The process of credit creation can be studied in two parts:

(1) Single Banking System

(2) Multiple Banking System

(1) **Credit Creation in a Single Banking System:** It means there is only one bank in the country. All transactions are done by this bank only. There can be two basis of credit creation.

(2) **Basis of Credit Multiplies:** Suppose a person deposits Rs.10000 in a bank. This amount of Rs.10000 will become primary deposit. Bank knows by experience that all depositors do not withdraw their money at one time. Thus, let us suppose bank kept 10% of total deposits in cash and advances the remaining as loans. Hence, bank keeps Rs.1000 in cash and the remaining amount of Rs.9000 is given as loan to Mr. 'A'. Bank does not give this loan in cash but opens a current account in his favour and credits this amount of Rs.9000 into this account. Bank permits Mr. 'A' to issue cheques to the amount of Rs.9000 only. Let us suppose that Mr. 'A' owes Rs.9000 to one Mr. 'B' and he discharges this liability by issuing him a cheque for Rs.9000 only. Mr. 'B' deposits this cheque in the same bank in his account. The bank will debit Rs.9000 lying in the account of Mr. 'A' and credit the same to the account of Mr. 'B'. In this way, there will be an increase in the deposits of the bank to the extent of Rs.9000. The bank will keep 10% of this deposit as its reserve and give a loan of Rs.8100 to yet another borrower Mr. 'C'. The process will thus go on for a long time.

Process can also be explained with the help of following table:

Process of Credit Creation

Round	**Primary Deposits**	**CRR 10%**	**Loans or Secondary Deposits**
First	10,000.00	1,000.00	9,000.00
Second	9,000.00	900.00	8,100.00
Third	8,100.00	810.00	7,290.00
Total	**27,100.00**	**2,710.00**	**24,390.00**

$$TD = PX\frac{1}{CRR}$$

It is clear from the above table that total created credit will be Rs.27100.00, out of which Rs.2710.00 will be kept by bank as CRR and the remaining Rs.24390.00 will constitute loans.

Credit Equation & Credit Multiplies: alike

Cash Reserve Ratio (r) = <u>Primary Deposit (P)</u>
Total Deposit (D)

If there is change in primary deposits then

$$r = \frac{\Delta P}{\Delta D} = \frac{1}{r}(Credit\ Multiples)$$

Total Increase in Bank Deposit = Primary Deposit in the First Round + Secondary Deposit in the 2nd Round + ... + Secondary Deposit in 9th Round

ΔD = ΔP + ΔP (1 – r) + ΔP (1 – r) 2 +. . . .. + ΔP (1 – r) n

- **Credit creation by multiple banking system:** In real world, there is not only one bank in economy, rather there are many banks functioning therein. A large single bank cannot create more credit than its excess reserve but multiple banking systems can create many times more credit than its primary deposits.
- **On the Basis of Credit Multiplies:** Supposing there are many banks in an economy. A person deposits with bank 'A' a sum of Rs.10000 in cash. Suppose bank keeps 10% of the total deposits as cash reserve and gives the remaining amount on loan. Bank A keeps Rs.1000 as cash and gives the remaining amount on loan. Bank 'B' keeps Rs.1000 as cash and gives Rs.9000 as loan to Mr. 'M'. This man issues a cheque of Rs.9000 to another person who has his account in Bank 'B'. That person deposits this cheque of Rs.9000 in bank 'B'. Now bank 'B' keeps 10 percent of Rs.9000, that is, Rs.900 as cash reserve and gives the remainder

Rs.8100 to a person who has his account in bank 'C'. Receipt amount of due cheque will therefore deposit the same in bank 'C'. In this way the primary deposits of bank 'C' will increase by Rs.8100. Now Bank 'C' will keep 10% of it i.e. Rs.810 as reserve and give the remainder amount of Rs.7200 as loan to another needy person. This process will continue till all banks create credit to the tune of Rs.90000 on the basis of a primary deposit of Rs.10000 only.

The process can be explained with the help of following table:

Banks	**Primary Deposits**	**Required Cash Reserve**	**Loans**
A	10,000.00	1,000.00	9,000.00
B	9,000.00	900.00	8,100.00
C	8,100.00	810.00	7,290.00
D	-	-	-
E	-	-	-
F	-	-	-
Total	**1,00,000.00**	**10,000.00**	**90,000.00**

Thus we can say that an increase in primary deposit amounting to Rs.10000 will ultimately enable the banking system to advance loans to the tune of Rs.9000, provided 10% of due primary deposit is kept as cash reserve. In other words, credit worth Rs.90000 will be created in the banking system as a whole.

5.8 SUMMARY

Banks are usually incorporated, and like any corporation must be backed by a certain amount of capital (money or other assets). Banking laws specify that banks must maintain a minimum amount of capital. Banks acquire capital by selling capital stock to shareholders. The money shareholders pay for the capital stock becomes the working capital of the bank. The working capital is put in a trust fund to protect the bank's depositors. In turn, shareholders receive certificates that prove their ownership of stock in the bank. The working capital of a bank cannot be diminished. Dividends to shareholders must be paid only from the profits or surplus of the bank.

Shareholders have their legal relationship with a bank defined by the terms outlined in the contract to purchase capital stock. With the investment in a bank come certain rights, such as the right to inspect the bank's books and records and the right to vote at shareholders' meetings. Shareholders may not personally sue a bank, but they can, under appropriate circumstances, bring a stockholder's derivative suit on behalf of the bank (sue a third party for injury done to the bank when the bank fails to sue on its own). Shareholders also are not usually personally liable for the debts and acts of a bank, because the corporate form limits their liability. However, if shareholders have consented to or accepted benefits of unauthorized banking practices or illegal acts of the board of directors, they are not immune from liability.

5.9 KEYWORDS

Saving Deposits, Fixed Deposits, Current Deposits, Recurring Deposits, Underwriting Of Shares, Foreign Exchange, Project Reports, Social Welfare Programmes, Paying Cheques, Collecting Cheques, Cash Reserve Ratio, Liquidity Preference, Bill Of Exchange, Tele Banking, Cash Credits.

5.10 REVIEW QUESTIONS

1. Define the term bank and explain the different functions of banks.
2. Differentiate between the primary and secondary functions of banks.
3. Explain the types of banks in detail.
4. Write down the note on recent trends in banks.

5. What is credit creation? Write down the various source of credit creation.
6. What are the limitations of credit creation?
7. Define the methods of credit creation.

5.11 FURTHER READINGS

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LESSION-7 MONEY MARKET

STRUCTURE

7.0 OBJECTIVES

After going through this lesson you will be able to:

- Describe the meaning of money market, its feature and various instruments.
- Understand the functions of money market in India.
- Main players of Indian money market,
- Features and drawback of Indian money market.

7.1 INTRODUCTION

There are two types of financial markets, the money market and the capital market. The money market is that part of a financial market which deals in the borrowing and lending of short term loans generally for a period of less than or equal to 365 days. It is a mechanism to clear short term monetary transactions in an economy. Money market is a very important segment of a financial system. It is the market for dealing in monetary assets of short-term nature. Short-term funds up to one year and financial assets that are close substitutes for money are dealt in the money market. Money market instruments have the characteristics of liquidity, minimum transaction cost and no loss in value. Excess funds are deployed in the money market, which in turn is availed of to meet temporary shortages of cash and other obligations. Money market provides access to providers and users of short-term funds to fulfil their investments and borrowings requirements respectively at an efficient market clearing price. It performs the crucial role of providing an equilibrating mechanism to even out short-term liquidity, surpluses and deficits and in the process, facilitates the conduct of monetary policy. The money market is one of the primary mechanism through which the Central Bank influences liquidity and the general level of interest rates in an economy. The Bank’s interventions to influence liquidity serve as a signalling-device for other segments of the financial system. The money market functions as a wholesale debt market for low-risk, highly liquid, short term instruments. Funds are available in this market for periods ranging from a single day to up to a year.

Mostly governments, banks and financial institutions dominate this market. It is a formal financial market that deals with short-term fund management. Though there are a few types of players in money market, the role and the level of participation by each type of player differs largely. Government is an active player in the money market and in most of the economies; it constitutes the biggest borrower in this market. Both, Government securities (G-Secs) and

Treasury bill (T-bill) is a security issued by RBI on behalf of the Government of India to meet the latter's borrowing for financing fiscal deficit. Apart from functioning as a banker to the government, the central bank (RBI) also regulates the money market and issues guidelines to govern the money market operations. Another dominant player in the money market is the banking industry. Banks mobilize deposits of savers inlending to investors of the economy. This process is known as credit creation. However, banks are not allowed to lend out the entire amount for extending credit for investment. In order to promote certain prudential norms for healthy banking practices, most of the developed economies require all commercial banks to maintain minimum liquid and cash reserves in form of Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) framed under the policies of central banks. The banks are required to ensure that these reserve requirements are met before directing deposits on their credit plans. If banks fall short of these statutory reserve requirements, the deficit amount can be raised using the money market. Other institutional players like financial institutions, corporates, mutual funds (MFs), Foreign institutional investors (FIIs) etc. also transact in money market to fulfil their respective short term finance deficits and short falls. However, the degree of participation of these players depends largely on the regulations formulated by the regulating authorities in an economy. For instance, the level of participation of the FIIs in the Indian money market is restricted to investment in government securities only.

7.2 MONEY MARKET: DEFINITION AND MEANING

Following definitions will help us to understand the concept of money market.

According to Crowther, "The money market is a name given to the various firms and institutions that deal in the various grades of near money."

According to the RBI, "The money market is the centre for dealing mainly of short character, in monetary assets; it meets the short term requirements of borrowers and provides liquidity or cash to the lenders. It is a place where short term surplus investible funds at the disposal of financial and other institutions and individuals are bid by borrowers, again comprising institutions and individuals and also by the government."

According to Nadler and Shipman, "A money market is a mechanical device through which short term funds are loaned and borrowed through which a large part of the financial transactions of a particular country or world are degraded. A money market is distinct from but supplementary to the commercial banking system."

These definitions help us to identify the basic characteristics of a money market. A money market comprises of a well organized banking system. Various financial instruments are used for transactions in a money market. There is perfect mobility of funds in a money market. The transactions in a money market are of short term nature.

7.3 FUNCTIONS OF MONEY MARKET

Money market is an important part of the economy. It plays very significant functions. As mentioned above it is basically a market for short term monetary transactions. Thus it has to provide facility for adjusting liquidity to the banks, business corporations, non-banking financial institutions (NBFs) and other financial institutions along with investors. The major functions of money market are given below:-

To maintain monetary equilibrium: It means to keep a balance between the demand for and supply of money for short term monetary transactions.

To promote economic growth: Money market can do this by making funds available to various units in the economy such as agriculture, small scale industries, etc.

To provide help to Trade and Industry: Money market provides adequate finance to trade and industry. Similarly it also provides facility of discounting bills of exchange for trade and industry.

To help in implementing Monetary Policy: It provides a mechanism for an effective implementation of the monetary policy.

To help in Capital Formation: Money market makes available investment avenues for short term period. It helps in generating savings and investments in the economy.

Money market provides non-inflationary sources of finance to government. It is possible by issuing treasury bills in order to raise short loans. However this dose not leads to increase in the prices. Apart from those, money market is an arrangement which accommodates banks and financial institutions dealing in short term monetary activities such as the demand for and supply of money.

7.4 MAIN PLAYERS OF INDIAN MONEY MARKET

Structure of Indian Money Market

The entire money market in India can be divided into two parts. They are organised money market and the unorganized money market. The unorganised money market can also be known as an unauthorized money market. Both of these components comprise several constituents. The following chart will help you in understanding the organisational structure of the Indian money market.

Indian money market is characterized by its dichotomy i.e. there are two sectors of money market, the organized sector and unorganized sector. The Organized sector is within the direct purview of RBI regulations. The unorganized sector consists of indigenous bankers, money lenders, non-banking financial institutions etc.

Organized Sector	**Unorganized Sector**
Call and Notice Money Market	Indigenous Bankers
Treasury Bill Market	Money Lenders
Commercial Bills	Non-bank financial institute (NBFI)
Certificate of Deposits	
Commercial Papers	
Money Market Mutual Funds	
The REPO Market (Repurchase Agreement)	
Discount and Finance House of India (DFHI)	

I. Organized Sector of Money Market:-

Organized Money Market is not a single market, it consist of number of markets. The most important feature of money market instrument is that it is liquid. It is characterised by high degree of safety of principal. Following are the instruments which are traded in money market

1) Call and Notice Money Market:-

The market for extremely short-period is referred to call money market. Under call money market, funds are transacted on overnight basis. The participants are mostly banks. Therefore it is also called Inter-Bank Money Market. Under notice money market funds are transacted for 2 days and

14 days period. The lender issues a notice to the borrower 2 to 3 days before the funds are to be paid. On receipt of notice, borrowers have to repay the funds. Call money is a method by which banks borrow from each other to be able to maintain the cash reserve ratio. The interest rate paid on call money loans is known as the call rate. It is a highly volatile rate that varies from day-to-day and sometimes even from hour-to-hour.

In this market the rate at which funds are borrowed and lent is called the call money rate. The call money rate is determined by demand and supply of short term funds. In call money market the main participants are commercial banks, co-operative banks and primary dealers. They participate as borrowers and lenders. Discount and Finance House of India (DFHI), Non-banking financial institutions like LIC, GIC, UTI, NABARD etc. are allowed to participate in call money market as lenders.

Call money markets are located in big commercial centres like Mumbai, Kolkata, Chennai, Delhi etc. Call money market is the indicator of liquidity position of money market. RBI intervenes in call money market as there is close link between the call money market and other segments of money market.

2) Treasury Bill Market (T - Bills):-

A Treasury bill is basically an instrument of short-term borrowing by the Government of India maturing in less than one year. They are also known as Zero Coupon Bonds issued by the Reserve Bank of India on behalf of the Central Government to meet its short-term requirement of funds. Treasury bills are issued in the form of a promissory note. They are issued at a price which is lower than their face value and repaid at par. The difference between the price at which the treasury bills are issued and their redemption value is the interest receivable on them and is called discount. At present three types of treasury bills are issued through auctions, namely 91 day, 182 day and 364 day treasury bills. State government does not issue any treasury bills. Interest is determined by market forces. Treasury bills are available for a minimum amount of Rs. 25,000 and in multiples of Rs. 25,000. Periodic auctions are held for their Issue. T-bills are highly liquid, readily available; there is absence of risk of default. In India T-bills have narrow market and are undeveloped. Commercial Banks, Primary Dealers, Mutual Funds, Corporates, Financial Institutions, Provident or Pension Funds and Insurance Companies can participate in T-bills market.

FEATURES OF TREASURY BILLS

(a) Form

The treasury bills are issued in the form of promissory note in physical form or by credit to Subsidiary General Ledger (SGL) account or Gilt account in dematerialized form.

(b) Minimum Amount of Bids

Bids for treasury bills are to be made for a minimum amount of ` 25000/- only and in multiples thereof.

(c) Eligibility

All entities registered in India like banks, financial institutions, Primary Dealers, firms, companies, corporate bodies, partnership firms, institutions, mutual funds, Foreign Institutional Investors, State Governments, Provident Funds, trusts, research organizations, Nepal Rashtra bank and even individuals are eligible to bid and purchase Treasury bills.

(d) Repayment

The treasury bills are repaid at par on the expiry of their tenure at the office of the Reserve Bank of India.

(e) Availability

All the treasury Bills are highly liquid instruments available both in the primary and secondary market.

(f) Day Count

For treasury bills the day count is taken as 365 days for a year.

BENEFITS OF INVESTMENT IN TREASURY BILLS

(a) No tax deducted at source

(b) Zero default risk being sovereign paper

(c) Highly liquid money market instrument

(d) Better returns especially in the short term

(e) Transparency

(f) Simplified settlement

(g) High degree of tradability and active secondary market facilitates meeting unplanned fund requirements.

3) Commercial Bills:-

Commercial bills are short term, negotiable and self liquidating money market instruments with low risk. A bill of exchange is drawn by a seller on the buyer to make payment within a certain period of time. Generally, the maturity period is of three months. Commercial bill can be resold a number of times during the usance period of bill. The commercial bills are purchased and discounted by commercial banks and are rediscounted by financial institutions like EXIM banks, SIDBI, IDBI etc.

In India, the commercial bill market is very much underdeveloped. RBI is trying to develop the bill market in our country. RBI has introduced an innovative instrument known as Derivative Usance Promissory Notes, with a view to eliminate movement of papers and to facilitate multiple rediscounting.

4) Certificate of Deposits (CDs):-

CDs are issued by Commercial banks and development financial institutions. CDs are unsecured, negotiable promissory notes issued at a discount to the face value. The scheme of CDs was introduced in 1989 by RBI. The main purpose was to enable the commercial banks to raise funds from market. At present, the maturity period of CDs ranges from 3 months to 1 year. They are issued in multiples of Rs. 25 lakh subject to a minimum size of Rs. 1 crore. CDs can be issued at discount to face value. They are freely transferable but only after the lock-in-period of 45 days after the date of issue.

In India the size of CDs market is quite small. In 1992, RBI allowed four financial institutions ICICI, IDBI, IFCI and IRBI to issue CDs with a maturity period of one year to three years.

5) Commercial Papers (CP)

Commercial Papers were introduced in January 1990. Commercial paper is a short-term unsecured promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. It is issued by large and creditworthy companies to raise short-term funds at lower rates of interest than market rates. The original purpose of commercial paper was to provide short-terms funds for seasonal and working capital needs. The Commercial Papers can be issued by listed companies which have working capital of not less than Rs. 5 crores. They could be issued in multiple of Rs. 25 lakhs. The minimum size of issue being Rs. 1 crore. At present the maturity period of CPs ranges between 15 days to 1 year. CPs are issued at a discount to its face value and redeemed at its face value.

6) Money Market Mutual Funds (MMMFs)

A Scheme of MMMFs was introduced by RBI in 1992. The goal was to provide an additional short-term avenue to individual investors. In November 1995 RBI made the scheme more flexible. The existing guidelines allow banks, public financial institutions and also private sector institutions to set up MMMFs. The ceiling of Rs. 50 crores on the size of MMMFs stipulated earlier, has been withdrawn. MMMFs are allowed to issue units to corporate enterprises and others on par with other mutual funds. Resources mobilized by MMMFs are now required to be invested in call money, CD, CPs, Commercial Bills arising out of genuine trade transactions, treasury bills and government dated securities having an unexpired maturity upto one year. Since March 7, 2000 MMMFs have been brought under the purview of SEBI regulations. At present there are 3 MMMFs in operation.

7) The Repo Market

Repo was introduced in December 1992. Repo is a repurchase agreement. It means selling a security under an agreement to repurchase it at a predetermined date and rate. Repo transactions are affected between banks and financial institutions and among bank themselves, RBI also undertake Repo. In November 1996, RBI introduced Reverse Repo. It means buying a security on a spot basis with a commitment to resell on a forward basis. Reverse Repo transactions are affected with scheduled commercial banks and primary dealers. In March 2003, to broaden the Repo market, RBI allowed NBFCs, Mutual Funds, Housing Finance and Companies and Insurance Companies to undertake REPO transactions.

8) Discount and Finance House of India (DFHI)

In 1988, DFHI was set up by RBI. It is jointly owned by RBI, public sector banks and all India financial institutions which have contributed to its paid up capital. It is playing an important role in developing an active secondary market in Money Market Instruments. In February 1996, it was accredited as a Primary Dealer (PD). The DFHI deals in treasury bills, commercial bills, CDs, CPs, short term deposits, call money market and government securities.

II. Unorganized Sector of Money Market

The economy on one hand performs through organized sector and on other hand in rural areas there is continuance of unorganized, informal and indigenous sector. The unorganized money market mostly finances short-term financial needs of farmers and small businessmen. The main constituents of unorganized money market are:-

1) Indigenous Bankers (IBs)

Indigenous bankers are individuals or private firms who receive deposits and give loans and thereby operate as banks. IBs accept deposits as well as lend money. They mostly operate in urban areas, especially in western and southern regions of the country. The volume of their credit operations is however not known. Further their lending operations are completely unsupervised and unregulated. Over the years, the significance of IBs has declined due to growing Organized banking sector.

2) Money Lenders (MLs)

They are those whose primary business is money lending. Money lending in India is very popular both in urban and rural areas. Interest rates are generally high. Large amount of loans are given for unproductive purposes. The operations of money lenders are prompt, informal and flexible. The borrowers are mostly poor farmers, artisans, petty traders and manual workers. Over the years the role of money lenders has declined due to the growing importance of Organized banking sector.

3) Non - Banking Financial Companies (NBFCs)

These companies are consists of:-

1. Chit Funds

Chit funds are savings institutions. It has regular members who make periodic subscriptions to the fund. The beneficiary may be selected by drawing of lots. Chit fund is more popular in Kerala and Tamilnadu. RBI has no control over the lending activities of chit funds.

2. Nidhis

Nidhis operate as a kind of mutual benefit for their members only. The loans are given to members at a reasonable rate of interest. Nidhis operate particularly in South India.

3. Loan or Finance Companies

Loan companies are found in all parts of the country. Their total capital consists of borrowings, deposits and owned funds. They give loans to retailers, wholesalers, artisans and self employed persons. They offer a high rate of interest along with other incentives to attract deposits. They charge high rate of interest varying from 36% to 48% p.a.

4. Finance Brokers

They are found in all major urban markets especially in cloth, grain and commodity markets. They act as middlemen between lenders and borrowers. They charge commission for their services.

FEATURES OF INDIAN MONEY MARKET

Every money has its own unique nature. The money market in developed and developing countries differ markedly from each other in many senses. Indian money market is not an exception for this. Though it is not a developed money market, it is a leading money market among the developing countries.

Indian Money Market has the following major features or characteristics:-

a. Dichotomy Structure

It is a significant aspect of the Indian money market. It has a simultaneous existence of both the organized money market as well as unorganised money market. The organized money market consists of RBI, all scheduled commercial banks and other recognized financial institutions. However, the unorganized part of the money market comprises domestic money lenders, indigenous bankers, trader, etc. The organized money market is in full control of the RBI. However, unorganized money market remains outside the RBI control. Thus both the organized and unorganized money market exists simultaneously.

b. Seasonality

The demand for money in Indian money market is of a seasonal nature. India being an agriculture predominant economy, the demand for money is generated from the agricultural operations. During the busy season i.e. between October and April more agricultural activities takes place leading to a higher demand for money.

Multiplicity of Interest Rates : In Indian money market, we have many levels of interest rates. They differ from bank to bank from period to period and even from borrower to borrower. Again in both organized and unorganized segment the interest rates differs. Thus there is an existence of many rates of interest in the Indian money market.

c. Lack of Organized Bill Market

In the Indian money market, the organized bill market is not prevalent. Though the RBI tried to introduce the Bill Market Scheme (1952) and then New Bill Market Scheme in 1970, still there is no properly organized bill market in India.

d. Absence of Integration

This is a very important feature of the Indian money market. At the same time it is divided among several segments or sections which are loosely connected with each other. There is a lack of coordination among these different components of the money market. RBI has full control over the components in the organized segment but it cannot control the components in the unorganized segment.

e. High Volatility in Call Money Market

The call money market is a market for very short term money. Here money is demanded at the call rate. Basically the demand for call money comes from the commercial banks. Institutions such as the GIC, LIC, etc suffer huge fluctuations and thus it has remained highly volatile.

f. Limited Instruments

It is in fact a defect of the Indian money market. In our money market the supply of various instruments such as the Treasury Bills, Commercial Bills, Certificate of Deposits, Commercial Papers, etc. are very limited. In order to meet the varied requirements of borrowers and lenders, it is necessary to develop numerous instruments.

DRAWBACKS OF INDIAN MONEY MARKET

Though the Indian money market is considered as the advanced money market among developing countries, it still suffers from many drawbacks or defects. These defects limit the efficiency of our market.

Some of the important defects or drawbacks of Indian money market are :-

a. Absence of Integration

The Indian money market is broadly divided into the Organized and Unorganized Sectors. The former comprises the legal financial institutions backed by the RBI. The unorganized statement of it includes various institutions such as indigenous bankers, village money lenders, traders, etc. There is lack of proper integration between these two segments.

b. Multiple rate of interest

In the Indian money market, especially the banks, there exist too many rates of interests. These rates vary for lending, borrowing, government activities, etc. Many rates of interests create confusion among the investors.

c. Insufficient Funds or Resources

The Indian economy with its seasonal structure faces frequent shortage of financial recourse. Lower income, lower savings, and lack of banking habits among people are some of the reasons for it.

d. Shortage of Investment Instruments

In the Indian money market, various investment instruments such as Treasury Bills, Commercial Bills, Certificate of Deposits, Commercial Papers, etc. are used. But taking into account the size of the population and market these instruments are inadequate.

e. Shortage of Commercial Bill

In India, as many banks keep large funds for liquidity purpose, the use of the commercial bills is very limited. Similarly since a large number of transactions are preferred in the cash from the scope for commercial bills are limited.

f. Lack of Organized Banking System

In India even though we have a big network of commercial banks, still the banking system suffers from major weaknesses such as the NPA, huge losses, and poor efficiency. The absence of the organized banking system is major problem for Indian money market.

g. Less number of Dealers

There are poor number of dealers in the short-term assets who can act as mediators between the government and the banking system. The less number of dealers leads tc the slow contact between the end lender and end borrowers. These are some of the major drawbacks of the Indian money market; many of these are also the features of our money market.

7.5 SUMMARY

There are two types of financial markets viz., the money market and the capital market. The money market is that part of a financial market which deals in the borrowing and lending of short term loans generally for a period of less than or equal to 365 days. Short-term funds up to one year and financial assets that are close substitutes for money are dealt in the money market. Money market provides access to providers and users of short-term funds to fulfill their investments and borrowings requirements respectively at an efficient market clearing price. Apart from functioning as a banker to the government, the central bank (RBI) also regulates the money market and issues guidelines to govern the money market operations. Apart from those, money market is an arrangement which accommodates banks and financial institutions dealing in short term monetary activities such as the demand for and supply of money.
They are organized money market and the unorganized money market. The unorganized money market can also be known as an unauthorized money market. Organized Money Market is not a single market, it consist of number of markets. Call money market is the indicator of liquidity position of money market. RBI intervenes in call money market as there is close link between the call money market and other segments of money market. The DFHI deals in treasury bills, commercial bills, CDs, CPs, short term deposits, call money market and government securities. Though it is not a developed money market, it is a leading money market among the developing countries. It has a simultaneous existence of both the organized money market as well as unorganized money market. In the Indian money market, the organized bill market is not common. Though the RBI tried to introduce the Bill Market Scheme (1952) and then New Bill Market Scheme in 1970, still there is no properly organized bill market in India. The call money market is a market for very short term money. Though the Indian money market is considered as the advanced money market among developing countries, it still suffers from many drawbacks or

defects. In the Indian money market, various investment instruments such as Treasury Bills, Commercial Bills, Certificate of Deposits, Commercial Papers, etc.

7.6 KEYWORDS

Money Market : It is the market for dealing in monetary assets of short-term nature.

Money Market Instruments : the instruments with the characteristics of liquidity, minimum transaction cost and no loss in value.

Call and Notice Money Market : The market for funds where transactions are taken place on overnight is referred to call money market.

A Treasury Bill : is basically an instrument of short-term borrowing by the Government of India maturing in less than one year.

Commercial Bills : are short term, negotiable and self liquidating money market instruments with low risk.

Certificate of Deposits (CDs) : are unsecured, negotiable promissory notes issued at a discount to the face value.

Commercial Paper : is a short-term unsecured promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period.

The Repo Market : selling a security under an agreement to repurchase it at a predetermined date and rate.

7.7 REVIEW QUESTIONS

1. Define the Money Market. What are the main functions of Money Market?
2. What do you understand by Money Market? What are the players in Indian Money Market?

3. Explain the features of Indian Money Market.
4. Discuss the drawback of Indian Money Market.
5. "Money market is very important segment of Indian Financial System". Comment and discuss various features of money market.

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LESSON-6
CENTRAL BANKING

STRUCTURE

6.0 OBJECTIVES

The key purpose of this chapter is to know about the terminology 'Central Banking' and its various roles in developing economy.

1. To study about the mean of Central Banking and role of central bank in development economy.
2. How the function of a central bank differ from country to country in accordance with the prevailing economic situation.
3. History, organization and structure of Reserve Bank of India, how it is supervised the monetary policy and fiscal policy.

6.1 INTRODUCTION

A central bank, reserve bank, or monetary authority is a public institution that manages a state's currency, money supply, and interest rates. Central banks also usually oversee the commercial banking system of their respective countries. In contrast to a commercial bank, a central bank possesses a monopoly on increasing the amount of money in the nation, and usually also prints the national currency, which usually serves as the nation's legal tender. For examples European Central Bank (ECB) and the Federal Reserve of the United States. http://en.wikipedia.org/wiki/Central_bank - cite_note-3

The primary function of a central bank is to manage the nation's money supply (monetary policy), through active duties such as managing interest rates, setting the reserve requirement, and acting as a lender of last resort to the banking sector during times of bank insolvency or financial crisis. Central banks usually also have supervisory powers, intended to prevent bank runs and to reduce the risk that commercial banks and other financial institutions engage in reckless or fraudulent behavior. Central banks in most developed nations are institutionally designed to be independent from political interference.

The chief executive of a central bank is normally known as the Governor, President or Chairman especially the US Federal Reserve's Board of Governors.

Functions of a central bank may include:

- Implementing monetary policies.
- Determining Interest rates
- Controlling the nation's entire money supply
- The Government's banker and the bankers' bank ("lender of last resort")
- Managing the country's foreign exchange and gold reserves and the Government's stock register

- Regulating and supervising the banking industry
- Setting the official interest rate – used to manage both inflation and the country's exchange and ensuring that this rate takes effect via a variety of policy mechanisms

BANKING IN INDIA

In the modern sense originated in the last decades of the 18th century. The first banks were Bank of Hindustan (1770-1829) and The General Bank of India, established 1786. The largest bank, and the oldest still in existence, is the State Bank of India, which originated in the Bank of Calcutta in June 1806, which almost immediately became the Bank of Bengal. This was one of the three presidency banks, the other two being the Bank of Bombay and the Bank of Madras, all three of which were established under charters from the British East India Company. The three banks merged in 1921 to form the Imperial Bank of India, which, upon India's independence, became the State Bank of India in 1955. For many years the presidency banks acted as quasi-central banks, as did their successors, until the Reserve Bank of India was established in 1935.

In 1969 the Indian government nationalized all the major banks that it did not already own and these have remained under government ownership. They are run under a structure know as 'profit-making public sector undertaking' (PSU) and are allowed to compete and operate as commercial banks. The Indian banking sector is made up of four types of banks, as well as the PSUs and the state banks; they have been joined since 1990s by new private commercial banks and a number of foreign banks.

Banking in India was generally fairly mature in terms of supply, product range and reach-even though reach in rural India and to the poor still remains a challenge. The government has developed initiatives to address this through the State bank of India expanding its branch network and through the National Bank for Agriculture and Rural Development with things like microfinance.

6.2 DEFINITION AND MEANING

The entity responsible for overseeing the monetary system for a nation (or group of nations). Central Banks have a wide range of responsibilities, from overseeing monetary policy to implementing specific goals such as currency stability, low inflation and full employment. Central banks also generally issue currency, function as the bank of the government, regulate the credit system, oversee commercial banks, manage exchange reserves and act as a lender of last resort.

The central banking system in the U.S. is known as the Federal Reserve System (commonly known as "the Fed"), which is composed of 12 regional Federal Reserve Banks located in major cities throughout the country. The main tasks of the Federal Reserve are to supervise and regulate banks, implement monetary policy by buying and selling U.S. Treasury bonds and steer interest rates. Ben Bernanke currently serves as the chairman of the Board of Governors of the Federal Reserve.

6.3 ROLE OF CENTRAL BANK IN DEVELOPING ECONOMY

1. **Issuer of currency**: Except for issuing one rupee notes and coins, RBI is the sole authority for the issue of currency in India. The Indian government issues one rupee notes and coins. Major currency is in the form of RBI notes, such as notes in the denominations of two, five, ten, twenty, fifty, one hundred, five hundred, and one thousand. Earlier, notes of higher denominations were also issued. But, these notes were demonetized to discourage users from indulging in black-market operations. RBI has two departments - the Issue department and Banking department. The issue department is dedicated to issuing currency. All the currency issued is the monetary liability of RBI that is backed by assets of equal value held by this department. Assets consist of gold, coin, bullion, foreign securities, rupee coins, and the government’s rupee securities. The department acquires these assets whenever required by issuing currency. The conditions governing the composition of these assets determine the nature of the currency standard that prevails in India.

The Banking department of RBI looks after the banking operations. It takes care of the currency in circulation and its withdrawal from circulation. Issuing new currency is known as expansion of currency and withdrawal of currency is known as contraction of currency.

2. **Banker to the Government**: RBI acts as banker, both to the central government and state governments. It manages all the banking transactions of the government involving the receipt and payment of money. In addition, RBI remits exchange and performs other banking operations. RBI provides short-term credit to the central government. Such credit helps the government to meet any shortfalls in its receipts over its disbursements. RBI also provides short term credit to state governments as advances. RBI also manages all new issues of government loans, servicing the government debt outstanding, and nurturing the market for government's securities. RBI advises the government on banking and financial subjects, international finance, financing of five-year plans, mobilizing resources, and banking legislation.

3. **Managing Government Securities**: Various financial institutions such as commercial banks are required by law to invest specified minimum proportions of their total assets/liabilities in government securities. RBI administers these investments of institutions.

The other responsibilities of RBI regarding these securities are to ensure -

1. Smooth functioning of the market
2. Readily available to potential buyers
3. Easily available in large numbers
4. Undisturbed maturity-structure of interest rates because of excess or deficit supply
5. Not subject to quick and huge fluctuations
6. Reasonable liquidity of investments
7. Good reception of the new issues of government loans

4. **Banker to Other Banks**: The role of RBI as a banker to other banks is as follows:

1. Holds some of the cash reserves of banks
2. Lends funds for short period
3. Provides centralized clearing and quick remittance facilities

RBI has the authority to statutorily ensure that the scheduled commercial banks deposit a stipulated ratio of their total net liabilities. This ratio is known as cash reserve ratio [CRR]. However, banks can use these deposits to meet their temporary requirements for interbank clearing as the maintenance of CRR is calculated based on the average balance over a period.

5. **Controller of Money Supply and Credit:** In a planned economy, the central bank plays an important role in controlling the paper currency system and inflationary tendency. RBI has to regulate the claims of competing banks on money supply and credit. RBI also needs to meet the credit requirements of the rest of the banking system. RBI needs to ensure promotion of maximum output, and maintain price stability and a high rate of economic growth. To perform these functions effectively, RBI uses several control instruments such as -

1. Open Market Operations
2. Changes in statutory reserve requirements for banks
3. Lending policies towards banks
4. Control over interest rate structure
5. Statutory liquidity ration of banks

6. **Exchange Manager and Controller:** RBI manages exchange control, and represents India as a member of the International Monetary Fund [IMF]. Exchange control was first imposed in India on September 1939 when World War II started and continues till date. Exchange control was imposed on both receipts and payments of foreign exchange.

According to foreign exchange regulations, all foreign exchange receipts, whether on account of export earnings, investment earnings, or capital receipts, whether of private or government accounts, must be sold to RBI either directly or through authorized dealers. Most commercial banks are authorized dealers of RBI.

7. **Publisher of Monetary Data and Other Data:** RBI maintains and provides all essential banking and other economic data, formulating and critically evaluating the economic policies in India. In order to perform this function, RBI collects, collates and publishes data regularly. Users can avail this data in the weekly statements, the RBI monthly bulletin, annual report on currency and finance, and other periodic publications.

6.4 FUNCTIONS OF CENTRAL BANK

As a central bank, the Reserve Bank has significant powers and duties to perform. For smooth and speedy progress of the Indian Financial System, it has to perform some important tasks. Among others it includes maintaining monetary and financial stability, to develop and maintain stable payment system, to promote and develop financial infrastructure and to regulate or control the financial institutions. For simplification, the functions of the Reserve Bank are classified into the traditional functions, the development functions and supervisory functions.

- **Traditional Functions of Central Bank**

Traditional functions are those functions which every central bank of each nation performs all over the world. Basically these functions are in line with the objectives with which the bank is set up. It includes fundamental functions of the Central Bank. They comprise the following tasks.

a) **Issue of Currency Notes:** The RBI has the sole right or authority or monopoly of issuing currency notes except one rupee note and coins of smaller denomination. These currency notes are legal tender issued by the RBI. Currently it is in denominations of Rs. 2, 5, 10, 20, 50, 100, 500, and 1,000. The RBI has powers not only to issue and withdraw but even to exchange these currency notes for other denominations. It issues these notes against the security of gold bullion, foreign securities, rupee coins, exchange bills and promissory notes and government of India bonds.

b) **Banker to other Banks:** The RBI being an apex monitory institution has obligatory powers to guide, help and direct other commercial banks in the country. The RBI can control the volumes of banks reserves and allow other banks to create credit in that proportion. Every commercial bank has to maintain a part of their reserves with its parent's viz. the RBI. Similarly in need or in urgency these banks approach the RBI for fund. Thus it is called as the lender of the last resort.

c) **Banker to the Government:** The RBI being the apex monitory body has to work as an agent of the central and state governments. It performs various banking function such as to accept deposits, taxes and make payments on behalf of the government. It works as a representative of the government even at the international level. It maintains government accounts, provides financial advice to the government. It manages government public debts and maintains foreign exchange reserves on behalf of the government. It provides overdraft facility to the government when it faces financial crunch.

d) **Exchange Rate Management**: It is an essential function of the RBI. In order to maintain stability in the external value of rupee, it has to prepare domestic policies in that direction. Also it needs to prepare and implement the foreign exchange rate policy which will help in attaining the exchange rate stability. In order to maintain the exchange rate stability it has to bring demand and supply of the foreign currency (U.S Dollar) close to each other.

e) **Credit Control Function:** Commercial bank in the country creates credit according to the demand in the economy. But if this credit creation is unchecked or unregulated then it leads the economy into inflationary cycles. On the other credit creation is below the required limit then it harms the growth of the economy. As a central bank of the nation the RBI has to look for growth with price stability. Thus it regulates the credit creation capacity of commercial banks by using various credit control tools.

f) **Supervisory Function:** The RBI has been endowed with vast powers for supervising the banking system in the country. It has powers to issue license for setting up new banks, to open new branches, to decide minimum reserves, to inspect functioning of commercial banks in India and abroad, and to guide and direct the commercial banks in India. It can have periodical inspections and audit of the commercial banks in India.

- **Developmental / Promotional Functions of central banks**

Along with the routine traditional functions, central banks especially in the developing country like India have to perform numerous functions. These functions are country specific functions and can change according to the requirements of that country. The RBI has been performing as a promoter of the financial system since its inception. Some of the major development functions of the RBI are maintained below.

a. **Development of the Financial System:** The financial system comprises the financial institutions, financial markets and financial instruments. The sound and efficient financial system is a precondition of the rapid economic development of the nation. The RBI has encouraged establishment of main banking and non-banking institutions to cater to the credit requirements of diverse sectors of the economy.

b. **Development of Agriculture:** In an agrarian economy like ours, the RBI has to provide special attention for the credit need of agriculture and allied activities. It has successfully rendered service in this direction by increasing the flow of credit to this sector. It has earlier the Agriculture Refinance and Development Corporation (ARDC) to look after the credit, National Bank for Agriculture and Rural Development (NABARD) and Regional Rural Banks (RRBs).

c. **Provision of Industrial Finance:** Rapid industrial growth is the key to faster economic development. In this regard, the adequate and timely availability of credit to small, medium and large industry is very significant. In this regard the RBI has always been instrumental in setting up special financial institutions such as ICICI Ltd. IDBI, SIDBI and EXIM BANK etc.

d. **Provisions of Training:** The RBI has always tried to provide essential training to the staff of the banking industry. The RBI has set up the bankers' training colleges at several places. National Institute of Bank Management i.e NIBM, Bankers Staff College i.e BSC and College of Agriculture Banking i.e CAB are few to mention.

e. **Collection of Data:** Being the apex monetary authority of the country, the RBI collects process and disseminates statistical data on several topics. It includes interest rate, inflation, savings and investments etc. This data proves to be quite useful for researchers and policy makers.

f. **Publication of the Reports:** The Reserve Bank has its separate publication division. This division collects and publishes data on several sectors of the economy. The reports and bulletins are regularly published by the RBI. It includes RBI weekly reports, RBI Annual Report, Report on Trend and Progress of Commercial Banks in India etc. This information is made available to the public also at cheaper rates.

g. **Promotion of Banking Habits:** As an apex organization, the RBI always tries to promote the banking habits in the country. It institutionalizes savings and takes measures for an expansion of the banking network. It has set up many institutions such as the Deposit Insurance Corporation-1962, UTI-1964, IDBI-1964, NABARD-1982, NHB-1988, etc. These organizations develop and promote banking habits among the people. During economic reforms it has taken many initiatives for encouraging and promoting banking in India.

h. **Promotion of Export through Refinance:** The RBI always tries to encourage the facilities for providing finance for foreign trade especially exports from India. The Export-Import Bank of India (EXIM Bank India) and the Export Credit Guarantee Corporation of India (ECGC) are supported by refinancing their lending for export purpose.

- **Supervisory Functions of central banks**

The reserve bank also performs many supervisory functions. It has authority to regulate and administer the entire banking and financial system. Some of its supervisory functions are given below.

a. **Granting license to banks:** The RBI grants license to banks for carrying its business. License is also given for opening extension counters, new branches, even to close down existing branches.

b. **Bank Inspection:** The RBI grants license to banks working as per the directives and in a prudent manner without undue risk. In addition to this it can ask for periodical information from banks on various components of assets and liabilities.

c. **Control over NBFIs:** The Non-Bank Financial Institutions are not influenced by the working of a monitory policy. However RBI has a right to issue directives to the NBFIs from time to time regarding their functioning. Through periodic inspection, it can control the NBFIs.

d. **Implementation of the Deposit Insurance Scheme:** The RBI has set up the Deposit Insurance Guarantee Corporation in order to protect the deposits of small depositors. All bank deposits below Rs. One lakh are insured with this corporation. The RBI work to implement the Deposit Insurance Scheme in case of a bank failure.

6.5 INTRODUCTION TO RBI

The Reserve Bank of India (RBI) is India's central banking institution, which controls the monetary policy of the Indian rupee. It was established on 1 April 1935 during the British Raj in accordance with the provisions of the Reserve Bank of India Act, 1934. The share capital was divided into shares of 100 each fully paid, which was entirely owned by private shareholders in the beginning. Following India's independence in 1947, the RBI was nationalized in the year 1949.

The RBI plays an important part in the development strategy of the Government of India. It is a member bank of the Asian Clearing Union. The general superintendence and direction of the RBI is entrusted with the 21-member strong Central Board of Directors The Governor (currently Raghu Ram Rajan), four Deputy Governors, two Finance Ministry representative, ten government-nominated directors to represent important elements from India's economy, and four directors to represent local boards headquartered at Mumbai, Kolkata, Chennai and New Delhi. Each of these local boards consists of five members who represent regional interests, as well as the interests of co-operative and indigenous banks.

The bank is also active in promoting financial inclusion policy and is a leading member of the Alliance for Financial Inclusion (AFI). View the bank on AFI's member map or read RBI financial inclusion-related news.

- **Functions of RBI**

a. **Bank of Issue:** Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. The distribution of one rupee notes, coins and small coins all over the country is undertaken by the Reserve Bank as agent of the government. The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes. The assets and liabilities of the Issue Department are kept separate from those of the Banking Department.

b. **Monetary authority:** The Reserve Bank of India is the main monetary authority of the country and beside that, in its capacity as the central bank, acts as the bank of the national and state governments. It formulates implements and monitors the monetary policy as well as it has to ensure an adequate flow of credit to productive sectors.

c. **Regulator and supervisor of the financial system:** The institution is also the regulator and supervisor of the financial system and prescribes broad parameters of banking operations within which the country's banking and financial system functions. Its objectives are to maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public. The Banking Ombudsman Scheme has been formulated by the Reserve Bank of India (RBI) for effective addressing of complaints by bank customers. The RBI controls the monetary supply, monitors economic indicators like the **gross domestic product** and has to decide the design of the rupee banknotes as well as coins.

d. **Managerial of exchange control:** The RBI is in charge of facilitating the achievement of the goals of the Foreign Exchange Management Act, 1999, objective: to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

e. **Issuer of currency:** The bank issues and exchanges or destroys currency notes and coins that are not fit for circulation. The objectives are giving the public adequate supply of currency of good quality and to provide loans to **commercial banks** to maintain or improve the GDP. The basic objectives of RBI are to issue bank notes, to maintain the currency and credit system of the country to utilize it in its best advantage, and to maintain the reserves. RBI maintains the economic structure of the country so that it can achieve the objective of price stability as well as economic development, because both objectives are diverse in themselves.

f. **Bankers of banks:** RBI also works as a central bank where commercial banks are account holders and can deposit money.RBI maintains banking accounts of all scheduled banks. Commercial banks create credit. It is the duty of the RBI to control the credit through the CRR, bank rate and open market operations. As banker's bank, the RBI facilitates the clearing of cheques between the commercial banks and helps inter-bank transfer of funds. It can grant financial accommodation to schedule banks. It acts as the lender of the last resort by providing emergency advances to the banks. It supervises the functioning of the commercial banks and take action against it if need arises.

g. **Detection of fake currency:** In order to curb the fake currency menace, RBI has launched a website to raise awareness among masses about fake notes in the market.www.paisaboltahai.rbi.org.in provides information about identifying fake currency.

h. **Developmental role** The central bank has to perform a wide range of promotional functions to support national objectives and industries. The RBI faces a lot of inter-sectoral and local inflation-related problems. Some of these problems are results of the dominant part of the public sector.

- **Related functions**

The RBI is also a banker to the government and performs merchant banking function for the central and the state governments. It also acts as their banker. The National Housing Bank (NHB) was established in 1988 to promote private real estate acquisition. The institution maintains banking accounts of all scheduled banks, too. RBI on 7 August 2012 said that Indian banking system is resilient enough to face the stress caused by the drought like situation because of poor monsoon this year.

a. **Bank Rate:** RBI lends to the commercial banks through its discount window to help the banks to meet depositor's demands and reserve requirements for long term. The Interest rate the RBI charges the banks for this purpose is called bank rate. If the RBI wants to increase the liquidity and money supply in the market, it will decrease the bank rate and if RBI wants to reduce the liquidity and money supply in the system, it will increase the bank rate.

b. **Reserve requirement cash reserve ratio (CRR):** Every commercial bank has to keep certain minimum cash reserves with RBI. Consequent upon amendment to sub-Section 42(1), the Reserve Bank, having regard to the needs of securing the monetary stability in the country, RBI can prescribe Cash Reserve Ratio (CRR) for scheduled banks without any floor rate or ceiling rate, [Before the enactment of this amendment, in terms of Section 42(1) of the RBI Act, the Reserve Bank could prescribe CRR for scheduled banks between 5% and 20% of total of their demand and time liabilities]. RBI uses this tool to increase or decrease the reserve requirement depending on whether it wants to affect a decrease or an increase in the money supply. An increase in Cash Reserve Ratio (CRR) will make it mandatory on the part of the banks to hold a large proportion of their deposits in the form of deposits with the RBI. This will reduce the size of their deposits and they will lend less. This will in turn decrease the money supply. The current rate is 4.75%. (As a Reduction in CRR by 0.25% as on 17 September 2012) -25 basis points cut in Cash Reserve Ratio

(CRR) on 17 September 2012. It will release Rs 17,000 crore into the system/Market. The RBI lowered the CRR by 25 basis points to 4.25% on 30 October 2012, a move it would inject about 175 billion rupees into the banking system in order to pre-empt potentially tightening liquidity. The latest CRR as on 29/01/13 is 4%

c. **Statutory Liquidity ratio (SLR):** Apart from the CRR, banks are required to maintain liquid assets in the form of gold, cash and approved securities. Higher liquidity ratio forces commercial banks to maintain a larger proportion of their resources in liquid form and thus reduces their capacity to grant loans and advances, thus it is an anti-inflationary impact. A higher liquidity ratio diverts the bank funds from loans and advances to investment in government and approved securities.

d. In well-developed economies, central banks use open market operations—buying and selling of eligible securities by central bank in the money market—to influence the volume of cash reserves with commercial banks and thus influence the volume of loans and advances they can make to the commercial and industrial sectors. In the open money market, government securities are traded at market related rates of interest. The RBI is resorting more to open market operations in the more recent years.

Generally RBI uses three kinds of selective credit controls:

1. Minimum margins for lending against specific securities.
2. Ceiling on the amounts of credit for certain purposes.
3. Discriminatory rate of interest charged on certain types of advances.

Direct credit controls in India are of three types:

1. Part of the interest rate structure i.e. on small savings and provident funds, are administratively set.

2. Banks are mandatory required to keep 23% of their deposits in the form of government securities.
3. Banks are required to lend to the priority sectors to the extent of 40% of their advances.

Policy Rates, Reserve Ratio, Lending and Deposit Rates as per April 2014.

Bank Rates	**9%**
Repo Rate	**8%**
Reserve Repo Rates	**7%**
Cash Reserve Ratio (CRR)	**4%**
Statutory Liquidity Ratio (SLR)	**23%**
Base Rate	**10%- 10.25%**
Saving Deposit Rate	**4%**
Term Deposit Rates	**8%- 9.50%**

6.6 ORGANIZATION AND STRUCTURE OF RBI

Central Board of Directors

The Central Board of Directors is the main committee of the central bank. The Government of India appoints the directors for a four-year term. The Board consists of a governor, four deputy governors, fifteen directors to represent the regional boards, one from the Ministry of Finance and ten other directors from various fields. The Government nominated Arvind Mayaram, as a director of the Central Board of Directors with effect from August 7, 2012 and vice R Gopalan, RBI said in a statement on August 8, 2012. . The Central Government has nominated Shri Rajiv Takru, Secretary, Department of Financial Services, Ministry of Finance, and New Delhi as a director on the Central Board of Directors of the Reserve Bank of India vice Shri D. K. Mittal. Shri Takru's nomination is with effect from February 4, 2013 and until further orders.

Governors

The current Governor of RBI is Raghu Ram Govind Rajan. There are four deputy governors, Deputy Governor S.S. Mundra, Urjit Patel, R. Gandhi and H.R. Khan.

Supportive bodies

The Reserve Bank of India has ten regional representations: North in New Delhi, South in Chennai, East in Kolkata and West in Mumbai. The representations are formed by five members, appointed for four years by the central government and serve—beside the advice of the Central Board of Directors—as a forum for regional banks and to deal with delegated tasks from the central board. The institution has 22 regional offices.

The Board of Financial Supervision (BFS), formed in November 1994, serves as a CCBD committee to control the financial institutions. It has four members, appointed for two years, and takes measures to strength the role of statutory auditors in the financial sector, external monitoring and internal controlling systems.

The Tarapore committee was set up by the Reserve Bank of India under the chairmanship of former RBI deputy governor S. S. Tarapore to "lay the road map" to capital account convertibility. The five-member committee recommended a three-year time frame for complete convertibility by 1999–2000.

On 1 July 2007, in an attempt to enhance the quality of customer service and strengthen the grievance redressal mechanism, the Reserve Bank of India created a new customer service department.

Offices and branches

The Reserve Bank of India has four zonal offices. It has 19 regional offices at most state capitals and at a few major cities in India. Few of them are location Ahmadabad, Bangalore, Bhopal, Bhubaneswar, Chandigarh, Chennai, Delhi, Guwaha, Hyderabad, Jaipur, Jammu, Kanpur, Kolkata, Lucknow, Mumbai, Nagpur, Patna and Thiruvananthapuram. Besides it has 9 sub offices at Agartala, Dehradun, Gangtok, Panaji, Raipur, Ranchi, Shillong, Shimla and Srinagar. The bank has also two training colleges for its officers, viz. Reserve Bank Staff College at Chennai and College of Agricultural Banking at Pune. There are real so four Zonal Training Centers at Mumbai, Chennai, Kolkata and New Delhi.

6.7 SUMMARY

- Name of Central Bank of India: Reserve Bank of India (RBI)
- No of Central Bank in India: One (1)
- Reserve Bank of India Act passed in 1934.
- Reserve Bank of India (RBI) established on 1 April 1935.
- Reserve Bank of India (RBI) established on the recommendation of Hilton-Young Commission.
- Hilton-Young Commission submitted its report in the year 1926.
- Initially RBI was constructed as a Private Share holders' bank with fully paid-up capital of Rs 5 Crores.
- RBI was nationalize in the year of 1st January,1949.
- RBI is a statutory body.
- RBI is the sole authority in India to issue Bank notes in India.

- RBI can issue currency notes as much as the country requires, provided it has to make a security deposit of Rs. 200 crores, out of which Rs.
- 115 crores must be in gold and Rs. 85 crores must be FOREX Reserves.
- Emblem of RBI: Panther and Palm Tree.
- Initially headquarter of RBI was in Calcutta (Now Kolkata) but in 1937 it was permanently moved to Mumbai, Maharashtra.
- The Reserve Bank of India has 19 regional offices, most of them in state capitals and 9 Sub-offices
- The Executive head of RBI is known as Governor.
- The governor is associated by Four Deputy Governors.
- 1st women Deputy Governor of RBI -K.J.Udeshi.
- RBI is not a Commercial Bank.
- RBI prints currency in 15 Languages.
- RBI is a member of IMF (International Monetary Fund).

6.8 KEYWORDS

Exchange Rate, Repo Rate, Reserve Repo Rates, Statutory Liquidity Ratio (SLR), Base Rate, Deposit Rates, Open Market Operations, Foreign Exchange, Agriculture Refinance and Development Corporation, National Bank for Agriculture and Rural Development, Regional Rural Banks.

6.9 REVIEW QUESTIONS

1. Define the role of central bank in developing economy.

2. What is meaning of central bank? Discuss the various functions of central bank.
3. Define central bank. Discuss the role of central bank in developing economy of a country.
4. Write a note on RBI.
5. Discuss the organization and structure of RBI.
6. Briefly discuss the function of RBI.

6.10 FURTHER READINGS

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LESSON-8 BANKER CUSTOMER RELATIONSHIP

STRUCTURE

8.0 OBJECTIVES

After going through this lesson, the learners will be able to:

• Describe and distinguish the term banking from any other commercial institution.

• Define the term ‘customer’ and a ‘bank’.

• Know the general relationship between banker and customer.

• Be familiar with the special features of the relationship between banker and customer.

8.1 INTRODUCTION

Banks and financial institutions are in the process of vast change due to the continuing financial sector reforms and the emerging competitive financial system within and outside the country. This is regular process of financial sector reforms, with its focus on allocative efficiency and stability. With the withdrawal of concessional sources of finance of banks and blurring of distinction between financial institutions and banks, financial institutions not only have to raise resources at market-related rates but also have to face a competitive environment on both asset and liability sides. Banks are becoming increasingly complex organizations. Investors are finding it difficult to understand the quality of financial performance and risk exposures of banks.

The conventional set of information as enclosed in banks' balance sheet often fails to express information to readers of financial statements that can enable them to determine the quality of earnings. Accordingly, supervisors world-wide are making conscious efforts towards increasing the quality and quantity of disclosures in banks' balance sheets. Transparency challenges are met where market participants not only make available information, but also place the information that makes it meaningful to exactly reflect risks. Increasing competition among banks, emanating not only from peers, but also from new entrants and other intermediaries, has been exerting pressure on bank spreads. The technology-intensive new private and foreign banks are positioning themselves as 'one-stop-shop' financial services and providing customers greater ease and high quality services backed by suitable investments in technology and other infrastructure. Therefore, the future profitability of public sector banks would depend on their ability to generate greater non-interest income and control operating expenses. Blue-chip clients continue to have the option to raise low-cost funds directly from domestic and international markets. The reforms-supported new environment is offering depositors and borrowers a wider range of opportunities to transact their business. Apart from the applicability of capital adequacy standards being in force, new methods of measuring market risk such as value-at-risk and pre-commitment approaches are expected to provide a more standardized but tighter framework for the banking sector. At the same time, the banking industry is undergoing a change driven by technological advancements. Since retail customers are becoming more demanding, in the competitive environment, banks have to offer the value-added services. After going over of this changed environment, banks are in the process of adjusting business relationship with their customer. The bank customer relationship is an emerging area that has attracted the concentration of many stakeholders in this regard. Ahead of take up the relationship that exists between a banker and his customer, let us make out the definitions of the term's 'banker' and 'customer'.

8.2 MEANING OF BANKER AND CUSTOMER

Before proceeding to discuss the relationship between Banker and Customer, it is essential to know the precise meaning of the words 'Banker' and 'Customer'.

Meaning of Banker

There are numerous definitions of the words 'Bank' and 'Banker'. But most of them are not satisfactory. The Banking Regulations Act (B R Act) 1949 does not define the term 'banker' but defines what banking is? As per Sec.5 (b) of the B R Act "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, order or otherwise." As per Sec. 3 of the Indian Negotiable Instruments Act 1881, the word "banker includes any person acting as banker and any post office savings bank". According to Sec. 2 of the Bill of Exchange Act, 1882, 'banker includes a body of persons, whether incorporated or not who carry on the business of banking.' Dr. H.C.

Hart has given a typical definition. According to him, "A banker of bank is a person or company carrying on the business of receiving money and collecting drafts, for customers subject to the obligation of honouring cheques drawn upon them from time to time by the customers to the extent of the amounts available in their Current Account".

The above definition insists on the following requirements before recognizing a person or institution as a banker or bank.

a) Acceptance of money on current account and the collection of cheques and drafts for the customer.

b) Payment of cheques or orders drawn by customers which are essentially payable on demand. Of course these instruments will be honoured to the extent amounts are available in the current account or up to an agreed overdraft limit, and

c) Banking business must be the main business of such person or company. This view was held in Stafford V. Henry (1850). In this case one, Lebertouche had carried on a very varied business, part of which was at that time regarded as banking, but as it was not his main business, it was held that he was not a banker.

The frequently used definition of a banker as a dealer in money and credit is not satisfactory, since there are many other forms of financial business other than banking which deal in money and credit e.g. money lenders deal in money and credit, they may even receive deposits, but do not come under the category of bankers. Similarly building societies receive deposits and they also provide credit but they are not banks. In both cases, demand deposits against which cheques can be drawn by customers are not kept.

Definition of a Customer

The term 'customer' of a bank is not defined by law. The word 'customer' has been derived from the word 'custom', which means a 'habit or tendency' to-do certain things in a regular or a particular manner's. In terms of Sec.131 of Negotiable Instrument Act, when a banker receives payment of a crossed cheque in good faith and without negligence for a customer, the bank does not incur any liability to the true owner of the cheque by reason only of having received such payment. It obviously means that to become a customer account relationship is must.

Ordinarily, a person who has an account in a bank is considered its customer. Banking experts and legal judgments in the past, however, used to qualify these statements by laying emphasis on the period for which such account had actually been maintained with the bank.

In Sir John's view "to constitute a customer there must be some recognizable course or habit of dealing in the nature of regular banking business". This definition of a customer of a bank lays emphasis on the duration of the dealings between the banker and the customers and is, therefore, called the 'duration theory'. According to this view point, a person does not become a customer of the banker on the opening of an account, he must have been accustomed to deal with the banker before he is designated as a customer.

According to Dr. Hart, "a customer is one who has an account with a banker or for whom a banker habitually undertakes to act as such".

"Broadly speaking, a customer is a person who has the habit of resorting to the same place or person to do business. So for as banking transactions are concerned he is a person whose money has been accepted on the footing that the banker will honour up to the amount standing to his credit. Irrespective of his connection being of short or long standing"

Thus, a person who has a bank account in his name and for whom the banker undertakes to provide the facilities as a banker, is considered to be a customer. It is not essential that the account must have been operated upon for some time. Even a single deposit in the account will be sufficient to designate a person as customer of the banker. Though, emphasis is not being laid on the habit of dealing with the banker in the past. Such habit may be expected to be developed and continued in future. In other words, Customer is expected to have regular dealings with his banker in future.

An important consideration which determines a person's status as a customer is the nature of his dealings with the banker. It is evident from the above that his dealing with the banker must be relating to the business of banking. A banker performs a number of agency functions and renders various public utility services besides performing essential functions as a banker A person who does not deal with the banker in regard to the essential functions of the banker, i. e. accepting of deposits and lending of money, but avails of any of the services rendered by the banker, is not called a customer of the banker. For example, any person without a bank account in his name my remit money through a bank draft, encash a cheque received by him from others or deposit his valuables in the safe deposit vaults in the bank or deposit cash in the bank to be credited to the account of the Life Insurance Corporation or any joint stock company issuing new shares But he will not be called a customer of the banker as his dealing with the banker are not in regard to the essential functions of the banker. Such dealing is considered as casual dealings and is not in the nature of banking business.

Thus to constitute a customer the following essential requisites must be fulfilled:

i) a bank account-savings, current or fixed deposit-must be opened in his name by making necessary deposit of money, and

ii) the dealing between the banker and the customer must be of the nature of banking business.

A customer of a banker need not necessarily be a person. A firm, joint stock company, a society or any separate legal entity may be a customer. Explanation to newly introduced Section "customer" includes a Government department and a corporation incorporated by or under any law.

Thus bank customers can be categorized into four broad categories as under:

(a) Those who maintain account relationship with banks i.e. Existing customers.

(b) Those who had account relationship with bank i.e. Former Customers

(c) Those who do not maintain any account relationship with the bank but frequently visit branch of a bank for availing banking facilities such as for purchasing a draft, encashing a cheque, etc. Technically they are not customers, as they do not maintain any account with the bank branch.

(d) Prospective/ Potential customers: Those who intend to have account relationship with the bank. A person will be deemed to be a 'customer' even if he had only handed over the account opening form duly filled in and signed by him to the bank and the bank has accepted the it for opening the account, even though no account has actually been opened by the bank in its books or record.

8.3 GENERAL RELATIONSHIP BETWEEN BANKER AND CUSTOMER

The relationship between a bank and its customers can be broadly categorized in to general relationship and special relationship. The relationship between a banker and a customer depends on the activities; products or services provided by bank to its customers or availed by the customer. Thus the relationship between a banker and customer is the transactional relationship. Bank's business depends much on the strong bondage with the customer. "Trust" plays an important role in building healthy relationship between a banker and customer. The relationship between a banker and his customer essentially flows from the contract. It is fundamentally the relationship of debtor and creditor, the respective positions being determined by the state of the account. However in relation to other services rendered by banker he is sometimes an agent of the customer, as for example, in collection of cheques, sale of securities, etc., bailee in relation to the safe custody of valuables; and trustee when he is entrusted with property to be administered for the benefit of a named beneficiary.

If we look at **Sec 5(b)** of Banking Regulation Act, we would notice that bank's business hovers around accepting of deposits for the purposes of lending. Thus the relationship arising out of these two main activities is known as General Relationship. In addition to these two activities banks also undertake other activities mentioned in Sec.6 of Banking Regulation Act. Relationship arising out of the activities mentioned in Sec.6 of the act is termed as special relationship.

General Relationship:

1. Debtor-Creditor: When a 'customer' opens an account with a bank, he fills in and signs the account opening form. By signing the form he enters into an agreement/contract with the bank. When customer deposits money in his account the bank becomes a debtor of the customer and customer a creditor. The money so deposited by customer becomes bank's property and bank has a right to use the money as it likes. The bank is not bound to inform the depositor the manner of utilization of funds deposited by him. Bank does not give any security to the depositor i.e. debtor. The bank has borrowed money and it is only when the depositor demands, banker pays. Bank's position is quite different from normal debtors. Banker does not pay money on its own, as banker is not required to repay the debt voluntarily. The demand is to be made at the branch where the account exists and in a proper manner and during working days and working hours. The debtor has to follow the terms and conditions of bank said to have been mentioned in the account opening form. (Though the terms and conditions are not mentioned in the account opening form, but the account opening form contains a declaration that the terms and conditions have been read and understood or has been explained). In fact the terms and conditions are mentioned in the passbook, which is issued to the customer only after the account has been opened.

In the past, while opening account some of the banks had the practice of giving a printed handbill containing the terms and conditions of account along with the account opening form. This practice has since been discontinued. For convenience and information of prospective customers a few banks have uploaded the account opening form, terms and conditions for opening account, rate charge in respect of various services provided by the bank etc., on their web site. While issuing Demand Draft, Mail / Telegraphic Transfer, bank becomes a debtor as it owns money to the payee/ beneficiary.

2. **Creditor–Debtor:** Lending money is the most important activities of a bank. The resources mobilized by banks are utilized for lending operations. Customer who borrows money from bank owns money to the bank. In the case of any loan/advances account, the banker is the creditor and the customer is the debtor. The relationship in the first case when a person deposits money with the bank reverses when he borrows money from the bank. Borrower executes documents and offer security to the bank before utilizing the credit facility. In addition to opening of a deposit/loan account banks provide variety of services, which makes

the relationship more wide and complex. Depending upon the type of services rendered and the

nature of transaction, the banker acts as a bailee, trustee, principal, agent, lessor, custodian etc.

Normally the customer is the creditor and the banker is the debtor. But when the account is overdrawn the roles are reversed. However there are certain differences between the ordinary commercial debts and the debts due from bankers.

i) The creditor must demand payment: In case of ordinary commercial debt the debtor pays the amount on the specified date or earlier of whenever demanded by the creditor as per the terms of the contract. But in case of a deposit in the bank, the debtor/baker is not required to repay the amount on his own accord. It is essential that the depositor (creditor) must make a demand for the payment of the deposit in the proper manner. This difference is up to he fact that a banker s not an ordinary debtor, he accepts the deposited with an additional obligation to honour his customer's cheques. If he returns the deposited amount on his own accord by closing the account, some of the cheques issued by the depositor might be dishonoured and his reputation might be adversely affected. Moreover, according to the statutory definition of banking the deposits are repayable in demand or otherwise. The depositor makes the deposit for his convenience, apart from his motive to earn an income (except current account). Demand by the creditor is, therefore, essential for the refund of the deposited money. Thus deposit made by a customer with his banker differs substantially from an ordinary debt.

ii) Proper place and time of demand: The demand by the creditor must be made at the proper place and in proper time. A commercial bank, having a number of branches, is considered to be one entity, but the depositor enters into relationship with only that branch where an account is opened in his name. His demand for the repayment of deposit must be made at the same branch of the bank concerned otherwise the banker is not bound to honour his commitment. However, the customer may make special arrangement with the banker for the repayment of the deposited money at some other branch. For example, in case of bank drafts, traveller's cheques etc., the branch receiving the money undertakes to repay it at a specified branch or any branch of the bank. It is also essential that the demand must be made during banking hours only on a working day of the bank. If the makes payment after or before the banking hours, he might be held liable for the same.

iii) Demand must be made in proper manner : According to the statutory definition of baking, deposits are withdrawable by cheques, drafts, order or otherwise. It means that the demand for the refund of money deposited must be made through a cheque or an order as per the common usage amongst the bankers. In other words, the demand should not be made verbally or through a telephonic message or in any such manner.

8.4 SPECIAL RELATIONSHIP BETWEEN BANKER AND CUSTOMER

1. Bank as a Trustee:

A trustee holds property for the beneficiary, and the profit earned from this property belongs to the beneficiary. If the customer deposits securities or valuables with the banker for safe custody, banker becomes a trustee of his customer. The customer is the beneficiary so the ownership remains with the customer. Thus trustee is the holder of property on behalf of a beneficiary. As per Sec. 15 of the 'Indian Trust Act, 1882 'A trustee is bound to deal with the trust-property as carefully as a man of ordinary prudence would deal with such property if it were his own; and, in the absence of a contract to the contrary, a trustee so dealing is not responsible for the loss, destruction or deterioration of the trust-property.' A trustee has the right to reimbursement of expenses (Sec.32 of Indian Trust Act.). In case of trust, banker-customer relationship is a special contract. When a person entrusts valuable items with another person with an intention that such items would be returned on demand to the keeper the relationship becomes of a trustee and trustier. Customers keep certain valuables or securities with the bank for safekeeping or deposits certain money for a specific purpose the banker in such cases acts as a trustee. Banks charge fee for safekeeping valuables.

2. Bailee – Bailor

The relationship between banker and customer can be that of Bailor and Bailee.

1. Bailment is a contract for delivering goods by one party to another to be held in trust for a specific period and returned when the purpose is ended.
2. Bailor is the party that delivers property to another.
3. Bailee is the party to whom the property is delivered.

Sec.148 of Indian Contract Act, 1872, defines "Bailment" "bailor" and "bailee". A "bailment" is the delivery of goods by one person to another for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them. The person delivering the goods is called the "bailor". The person to whom they are delivered is called, the "bailee". Banks secure their advances by obtaining tangible securities. In some cases physical possession of securities goods (Pledge), valuables, bonds etc., are taken. While taking physical possession of securities the bank becomes bailee and the customer bailor. Banks also keeps articles, valuables,securities etc., of its customers in Safe Custody and acts as a Bailee. As a bailee the bank isrequired to take care of the goods bailed.

3. Lessor and Lessee

Lessor, lessee, premium and rent can be defined as:

(1) The transferor is called the lessor,

(2) The transferee is called the lessee,

(3) The price is called the premium, and

(4)The money, share, service or other thing to be so rendered is called the rent.

Sec.105 of 'Transfer of property Act 1882' defines lease, Lessor, lessee, premium and rent. As per the section "A lease of immovable property is a transfer of a right to enjoy such property, made for a certain time, express or implied, or in perpetuity, in consideration of a price paid or promised, or of money, a share of crops, service or any other thing of value, to be rendered periodically or on specified occasions to the transferor by the transferee, who accepts the transfer on such terms. Providing safe deposit lockers is as an secondary service provided by banks to customers. The relationship between the bank and the customer is that of lessor and lessee. Banks lease (hire lockers to their customers) their immovable property to the customer and give them the right to enjoy such property during the specified period i.e. during the office/ banking hours and charge rentals. Bank has the right to break-open the locker in case the locker holder defaults in payment of rent. Banks do not assume any liability or responsibility in case of any damage to the contents kept in the locker. Banks do not insure the contents kept in the lockers by customers.

4. Agent and Principal

Sec.182 of 'The Indian Contract Act, 1872' defines "an agent" as a person employed to do any act for another or to represent another in dealings with third persons. The person for whom such act is done or who is so represented is called "the Principal". Thus an agent is a person, who acts for and on behalf of the principal and under the latter's express or implied authority and the acts done within such authority are binding on his principal and the principal is liable to the party for the acts of the agent. Banks collect cheques, bills and makes payment to various authorities viz., rent, telephone bills, insurance premium etc., on behalf of customers. Banks also take the standing instructions given by its customers. In all such cases bank acts as an agent of its customer, and charges for these services. As per Indian contract Act agent is entitled to charges. No charges are levied in collection of local cheques through clearing house. Charges are levied in only when the cheque is returned in the clearinghouse.

5. **As a Custodian:**

A custodian is a person who acts as a caretaker of something. Banks take legal responsibility for a customer's securities. While opening a demat account bank becomes a custodian.

6. As a Guarantor

Banks give guarantee on behalf of their customers and enter in to their shoes. Guarantee is a contingent contract. As per sec 31, of Indian contract Act guarantee is a "contingent contract ". Contingent contract is a contract to do or not to do something, if some event, collateral to such contract, does or does not happen. It would thus be observed that banker customer relationship is transactional relationship.

7. Relationship of Advisor and Client

When a customer invests in securities, the banker acts as an advisor. The advice can be given officially or unofficially. While giving advice the banker has to take maximum care and caution. Here, the banker is an Advisor, and the customer is a Client.

Other Relationships

Other miscellaneous banker-customer relationships are as follows:

- **Obligation to honor cheques** : As long as there is sufficient balance in the account of the customer, the banker must honor all his cheques. The cheques must be complete and in proper order. They must be presented within six months from the date of issue. However, the banker can refuse to honor the cheques only in certain cases.

- **Secrecy of customer's account** : When a customer opens an account in a bank, the banker must not give information about the customer's account to others.
- **Banker's right to claim incidental charges** : A banker has a right to charge a commission, interest or other charges for the various services given by him to the customer. For e.g. an overdraft facility.
- **Law of limitation on bank deposits** : Under the law of limitation, generally, a customer gives up the right to recover the amount due at a banker if he has not operated his account since last 10 years.

8.5 DUTIES (OBLIGATIONS) OF BANKER

A 'Banker' has certain duties to his customer. These are:

(a) Duty to maintain secrecy/confidentiality of customers' accounts.

(b) Duty to honour cheques drawn by customers on their accounts and collect cheque, bills on his behalf.

(c) Duty to pay bills etc., as per standing instructions of the customer.

(d) Duty to provide proper services.

(e) Duty to act as per the directions given by the customer. If directions are not given the banker has to act according to how he is expected to act.

(f) Duty to submit periodical statements i.e. informing customers of the state of the account

(g) Articles/items kept should not be released to a third party without due authorization by the customer

1. Duty to maintain secrecy:

Banker has a duty to maintain secrecy of customers' accounts. Maintaining secrecy is not only a moral duty but bank is legally bound to keep the affairs of the customer secret. The principle behind this duty is that disclosure about the dealings of the customer to any unauthorized person may harm the reputation of customer and the bank may be held liable. The duty of maintaining secrecy does not cease with the closing of account or on the death of the account holder.

As per Sec. 13 of "Banking Companies Acquisition and Transfer of Undertakings Act 1970"- "Every corresponding new bank shall observe, except as otherwise required by law, the practices and usages customary among bankers, and, in particular, it shall not divulge any information relating to or to the affairs of its constituents except in circumstances in which it is, in accordance with law or practices and usages customary among bankers, necessary or appropriate for the corresponding new bank to divulge such information." Maintaining secrecy is implied terms of the contract with the customer which bank enters into with the customer at the time of opening an account. Bank has not only to maintain secrecy of transactions, but secrecy is also to be maintained in respect of operations through ATM/ debit cards. Bank has also to maintain secrecy of user ID pins with due care so that it does fall in wrong hands.

Failure to maintain secrecy:

Bank is liable to pay damages to the account holder for loss of money and reputation if it fails in its duty to maintain secrecy and discloses information relating to a customer's account or conduct of the account to any unauthorized person. Bank can also be liable to the third party if its wrongful disclosure harms the interest of the third party. If bank willingly furnishes wrong information, there has been a misrepresentation. Over estimation of favourable opinion Circumstances under which banker can disclose information of customer's account:

A bank can disclose information regarding customer's account to a person(s) under the following circumstances.

(a) Under compulsion of law.

(b) Under banking practices.

(c) For protecting national interest.

(d) For protecting bank's own interest

(e) Under express or implied consent of the customer

Disclosure under compulsion of law:

Banks disclose information to various authorities who by virtue of powers vested in them under provisions of various Acts require banks to furnish information about customer's account. The information is called under:

(i) Section 4 of Banker's Book Evidence Act, 1891

(ii) Section 94 (3) of Code of Civil Procedure Act, 1908

(iii) Section 45 (B) of Reserve Bank of India Act, 1934

(iv) Section 26 of Banking Regulation Act, 1949

(v) Section 36 of Gift Tax Act, 1958

(vi) Sections 131, 133 of Income Tax Act, 1961

(vii) Section 29 of Industrial Development Bank of India Act, 1964

(viii) Section 12of Foreign Exchange Management Act, (FEMA) 1999

(ix) Section 12 of the Prevention of Money Laundering Act, 2002

Banks are required to furnish only the called for information (no additional information is to be furnished) on receipt of written request of the person who is vested with the authority to call for such information under the said acts. The customer is kept informed about the disclosure of the information.

Disclosure under banking practices:

In order to ascertain financial position and credit worthiness of the person banks obtain information from other banks with which they are maintaining accounts. It is an established practice among bankers and implied consent of the customer is presumed to exist. The opinion is given in strictest confidence and without responsibility on the part of the bank furnishing such information. Credit information is furnished in coded terms to other banks on IBA format and without signatures.

2. Duty to provide proper accounts

Banks are under duty bound to provide proper accounts to the customer of all the transactions done by him. Bank is required to submit a statement of accounts / passbook to the customer containing all the credits and debits in the account.

3. Duty to honour cheques

As 'banking' means accepting of deposits withdrawable by cheque, draft, order or otherwise, the banker is duty bound to honour cheques issued by the customers on their accounts. Sec. 31of

Negotiable Instruments Act, 1881 specifies the liability of drawee of cheque. As per Sec. 31 “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.”

Therefore it is the duty of a bank to honour the cheques issued by the account holder if: The cheque has been properly drawn and is in order in all respects i.e. it is properly dated, amount in words and figures have been expressed properly, is neither stated nor post dated nor mutilated and the signature of account holder tallies with the specimen recorded with the bank. The cheque should be drawn on the branch where the account is maintained. (Due to implementation of technology and core banking solution a customer can present cheques on any branch of a bank.

Duty to honour cheques ceases on receipt of:

(a) Stop payment instructions from the account holder.

(b) Notice about the death of the drawer.

(c) A garnishee order attaching the balance in the account or an income-tax attachment order received by the banker.

(d) Drawer of the cheque becoming insolvent and/or a lunatic at the time of drawing the cheque.

Bank can refuse to honour the cheques if:

There is in sufficient balance in the account to make payment of the cheque. Cheque issued does not pertain to the account on which it has been drawn. If the cheque is not in order (post dated, stale, payment countermanded, amount in words and figure differs, etc.) The balances held in account are earmarked for some specific purpose and the remaining balance is not sufficient to honor the cheque.

8.6 RIGHTS OF BANKER

1. Right of Lien

A lien is the right of a creditor in possession of goods, securities or any other assets belonging to the debtor to retain them until the debt is repaid, provided that there is no contract express or implied, to the contrary. It is a right to retain possession of specific goods or securities or other movables of which the ownership vests in some other person and the possession can be retained till the owner discharges the debt or obligation to the possessor. The creditor (bank) has the right to maintain the security of the debtor but not to sell it. There are two types of lien a) Right of General Lien and b) Right of Particular Lien

a) Right of General Lien

A Lien is the right to maintain the property belonging to a debtor until he has discharged the debt due to the retainer of the property. A lien is merely a right to retain and is lost when possession is lost. A lien may be either particular or general line. A particular lien arises from the particular transaction connected with the property subject to the lien; a general lien arises not merely out of the particular transaction, but for the general dealing between the two parties in respect of other transactions of similar character.

Particular lien is enjoyed by craftsmen like Tailors and Goldsmiths and Bailess like repairers and Public Carriers. For example a goldsmiths can retain the jewel till the charges are paid. In both cases the right of lien is not available for any other sums due.

Special Features of a Banker's Right of General Lien:

i) The banker possesses the right of general lien on all the goods and securities entrusted to him capacity as a banker and in the absence of a contract inconsistent with the right of line. Thus he cannot exercise his right of general lien if – a) the goods and securities have been entrusted to the banker as a trustee or an agent of the customer, and b) a contract-express or implied-exists between the customer and the banker which is inconsistent with the banker's right of general lien. In other words, if the goods or securities are entrusted for some specific purpose, the banker cannot have a lien over them. These exceptional cases are discussed later on.

ii) A banker's lien is equal to an implied pledge: As noted above the right of lien does not confer on the creditor the right of sale but only the right to retain the goods till the loan is repaid. In case of pledge the creditor enjoys the right of sale. A banker's right of lien is more than a general lien. It confers upon him the power to sell the goods and securities in case of default by the customer. Such right of lien thus resembles a pledge and is usually called an "implied pledge". The banker thus enjoys the privileges of a pledge and can dispose of the securities after giving proper notice to the customer.

iii) The right of lien is conferred upon the banker by the Indian Contract Act. No separate agreement of contract is, therefore, necessary for this purpose. However, to be on the safe side, the banker takes a letter of lien from the customer mentioning that the goods are entrusted to the banker as security for a loan-existing or future-taken from the banker and that the latter can exercise his right of lien over them. The banker is also authorized to sell the goods in case of default on the part of the customer. The latter thus spells out the object of entrusting the goods to the banker so that the same may not be denied by the customer later on.

iv) The tight of lien can be exercised on goods or other securities standing in the name of the borrower only and not jointly with others. For example, in case the securities are held in the joint names of two or more persons the banker cannot exercise his right of general lien in respect of a debt due from a single person.

v) The banker can implement his right of lien on the securities remaining in his possession after the loan, for which they were lodged, is repaid by the customer, if no contract to the contrary exists. In such cases it is an implied presumption that the customer has re-offered the same securities as a cover for any other advance outstanding on that date or taken subsequently. The banker is also entitled to exercise the right of general lien in respect of the customer's obligation as a surety and to retain the security offered by him for a loan obtained by him for his personal use and which has been repaid.

b) **Particular Lien**

A 'particular lien' gives the right to keep possession only of those goods in respect of which the dues have arisen. It is also termed as ordinary lien. If the bank has obtained a particular security for a particular debt, then the banker's right gets converted into a particular lien.

Cases where the Banker cannot Exercise His Right of Lien:

1. In the case of securities deposited with the banker for safe custody only, the banker is acting merely as a bailee, and has no lien over such articles.

2. In the case of funds and securities specifically appropriated, the banker cannot exercise his right of lien because there is an express contract inconsistent with the lien.

3. A general lien cannot arises in respect of property of a customer pledged as security for a particular debt.

4. The banker cannot exercise his right of lien in respect of property coming into his hands by mistake or which is placed in his hands to cover an advances that is not granted (Lucas V. Dorren).

5. No lien arises until the due date in respect of an advance of a specific amount made for a definite period.

6. No lien arises in case the credit and liability do not exist in the same right. Thus, the banker cannot exercise his right of lien over the securities or funds of a partner in respect of a debt due from the firm.

7. The banker cannot exercise his right of lien in respect of a separate account maintained by a customer which is known to the banker as a Trust Account.

8. No lien arises over properties on which the customer has no title.

9. Right of General Lien becomes that of Particular Lien.

2. Right to Set-off

The right of set-off is a statutory right which enables a debtor to take into account a debt owed to him by a creditor, before the latter could recover the debt due to him from the debtor. In other words, the mutual claims of debtor and creditor are adjusted to each other and only the remainder amount is payable by the debtor. A banker, like other debtors, possesses this right of set-off which enables him to combine two accounts in the name of the same customer and to adjust the debit balance in one account with the credit balance in the other. For example, A ha taken an overdraft from his banker to the extent of Rs. 5,000 and he has a credit balance to the extent of Rs. 2,000 in his savings bank account, the banker can combine both of these accounts and claim the remainder amount of Rs. 3,000 only. This right of set-off can be exercised by the banker if there is no agreement-express or implied-contrary to his right and after a notice is served on the customer intimating the latter about the former's intention exercise the right of set-off. To be on the safer side, the banker takes a letter of set-off from the customer authorizing the banker to exercise the right of set-off without giving him any notice.

Conditions of Set-off:

The right to combine accounts to exercise the right of set-off is enclose with qualifications, as noted before, and demands close study.

A banker has a right of set-off as between the current and fixed deposit accounts of a customer. This right of set-off exists whether the banker does or does nto hold the relative deposit receipt, and can be exercised although the customer after drawing the cheque may have become insolvent, and since the receipt is not negotiable or even transferable, this right of set-off is not defeated should the depositor have transferred his deposit receipt to a holder who takes it in good faith and for value.

Suppose a customer has a private account and also other accounts in his name designated as follows:

a. Estate Account
b. Executor of C deceased
c. Treasurer of the D School
d. Treasurer of the E Friendly Society
e. Annual Function Account.

If the customer overdraws any of the accounts (a) to (e), it is considered that he is personally liable for such overdrafts and that the bank would have a right of set-off against the credit balance on his private account, the reason being that all the accounts are in the customer's name. it does not follow that the bank (except in the case of Estate Account, if the 'estate' is the customer's own) has a corresponding right to set off credit balances on some of the designated accounts against overdraft on others of them, or on the private account. In the case of E Friendly Society the account should not have been opened in the name of an individual, but should have been opened in the name of the Society.

Debts Due in Different Rights: These debts cannot be set off on the principle that money of any person's cannot be used to pay off other person's debts, as shown in the following cases:

i) Separate and Joint Debts: Unless the parties have agreed to be jointly and severally liable for a joint debt, to right of set-off exists between customer's private account and any joint account in which his name appears, as they are not the debt due as between the same parties and in the same rights. Similarly, the joint credit balance cannot be set off against due in either of the sole names unless they have agreed with the bank that it may. But if it is shown that a joint account through kept in two names is really in trust for one of them, the amount due under one account can be set off against the amount due on another account.

Under the law prevailing in India, a deposit by a Hindu husband in the name of himself and his wife payable to either or survivor must, in the absence of evidence to the contrary, be presumed to belong to the husband. Thus, a credit balance in an account in the joint names of husband and wife can be set off against an overdraft in the sole name of the husband.

ii) Minor's Accounts and Private Account of Guardian: An account of a party as guardian for a minor is not to be treated in the same right as his own account with the banker and so the right of set-off is not available.

iii) A Partner's Private Account and the Firm's Account: It is an established rule that banker cannot set off the credit balance on a partner's private account against a debt due on the firm's account and vice versa as these are accounts not in the same right. But if the partners are jointly and severally responsible to the bank for any debt on the firm's account (as in usually the case), the banker would have the right to set off any credit balance on the partner's separate account against a debt on the firm's account. In such a case, a reasonable notice should first be given unless an authority to combine the accounts is held. In case of a sole trader, the account in his personal name and that in the firm's name are deemed to be in the same right and hence the right of set-off can be exercised in these accounts.

iv) Personal Accounts and Accounts in a Fiduciary Capacity: The money held by a person in his fiduciary capacity, i.e., as executor, administrator or trustee, cannot be set off against his private debt as the same are not held in the same capacity. But if the fiduciary account is overdrawn he is personally liable for the overdraft and his private credit balance can be set off against it, unless the term on which the overdraft was arranged is inconsistent with such a right of set-off. A customer who purchased a draft in his own name on behalf of a principle and refused to endorse was a trustee in respect of the draft amount and the banker could not set off the trust money against the liability of the customer in his private account. Similarly, the balance held in the client's account of an advocate is held by him as a trustee and is not to be treated to be held in the same capacity in which the amount is held in his private account. Again, a credit balance on an account in the name of executor as, for example, "A.B. Executor of X.Y. Deceased" is not good set-off against a debit balance standing on the account of X.Y. deceased.

Debts Due and Further or Contingent Debts

The right of set-off can be exercised in respect of debts due and not in respect of future or contingent debts. A debt not yet due cannot be set off against a debt already due. For example, a banker cannot set-off a debt due to him upon a loan account repayable on demand or at a certain future date against credit balance on current account for until demand or arrival of the due date the loan is not due for payment. Similarly, the banker has no right to set off a deposit balance against the depositor’s contingent liability on current discounted bills, but in the event of customer’s insolvency, the banker has a right to set off credit balance on the account against the contingent liability on any bill he has discounted for the customer. If the customer has a deposit account and is also a party to bill lying unpaid, the banker can refuse payment of the deposit to him and apply the amount or so much as is required, to the depositor’s matured obligation held by the bank.

Sale of Securities

Where a borrower has lodged securities as cover for an advance and if the banker applied the amount in satisfaction of the amount due and is left with a surplus, he has a right of set-off against the surplus for an overdraft on another account even though maintained at another branch of the same bank.

Stopped Accounts

In the case of ‘stopped’ accounts, the right of set-off becomes available to a banker automatically. An account is ‘stopped’ when a customer dies or is declared insolvent or insane, or by the service of a garnishee order. In such an event all the accounts of the customer in the same right must a immediately combined in order to ascertain how much is due to or from the customer’s estate. The same steps will be taken in the case of a failure of a firm or liquidation of a company. The accounts of a deceased customer are broken by his death and all the accounts may be combined, setting off any debt balances, before paving over to the legal personal representative of the deceased. Where a garnishee order is served in respect of a customer having more than one account in his own right, the banker has the right to first exercise the right of set-off before accounting to the judgment creditor.

If the trustee in bankruptcy of a customer, who has money on deposit and also an overdraft account, claims, by presenting the deposit receipt of pass book, to have the amount of deposit paid to him leaving the bank to prove the whole amount of the overdraft, the banker can refuse to oblige the trustee and set off the deposit against the overdraft.

Deceased Customer's Overdraft Account and the Account of Executors or Administrators

On the death of a customer having an overdrawn account, the bank cannot debit his executors or administrator's account without their authority even though the grant of probate or administration is produced because they cannot be made personally liable for the deceased's debt without their consent. Executors or administrators are personally (but jointly, not severally) liable for money which they borrow, and for other debts which they incur, in the course of their administering their testator's or in estate's estate, and their creditors are not the creditors of the estate. Even if they have an account in their joint names with a balance sufficient to discharge the debt, there is no right of set-off between that account and deceased's. The money in the hands of the personal representative is available for distribution amongst all the creditors of the estate.

If the deceased's account was overdrawn at the time of his death, the bank may continue to hold the securities, if any, deposited by the deceased against his overdraft, but if the executors or administrators take the overdraft into their own names (which they are not obliged to do), it becomes a personal liability of theirs, and ceases to be secured by securities deposited by the deceased, unless they are recharged by them to secure such liabilities. It is the practice of banks to obtain an acknowledgement of joint and several liabilities from joint executors or administrators before permitting overdrafts in their names. This is usually included in the mandate form.

Amounts of debts must be certain: It is essential that the debts due from both the parties to each other must be definitely ascertainable otherwise the right of set-off cannot be exercised. For example, a banker cannot set off credit balance in the account of a guarantor of a loan account till his liability as a guarantor is determined. If the guarantee is on demand, no debt in a owing by the guarantor payable until the demand is made and accordingly until then there can be no right of set off. As soon as the demand is made, the right of set-off can be exercised.

3. Banker's Right of Appropriation (Rule in Clayton's Case):

In the course of his usual business, a banker receives payments from his customer. If the latter has more than one account or has taken more than one loan from the banker, the question of appropriation of the money subsequently deposited by him naturally arises. Section 59 to 61 of the Indian Contract Act, 1872 contains provisions regarding the right of appropriation of payments in such cases.

According to Section 59 such right of appropriation is vested in the debtor who makes a payment to his creditor to whom he owns several debts. He can appropriate the payment to his creditor to whom he owes several debts. He can appropriate the payment by i) an express intimation r ii) under circumstances implying that the payment is to be applied accordingly. For example, A owes B served debts, including Rs. 1,000 upon promissory note which falls due on 1st December 1996. He owes B no other debt of the amount. On 1-12-1996 A pays B Rs. 1,000 the payment is to be applied to the discharge of the promissory note.

If the debtor does not intimate or there is no other circumstances indicating to which debt the payment are to be applied, the right of appropriation is vested in the creditor. He may apply it at his discretion to any lawful debt actually due and payable to him from the debtor. (Sec 60).

Further, where neither party makes any appropriation, the payment shall be applied in discharge of the debts in order of time. If the debts are of equal standing the payment shall applied in discharge of each proportionately (Sec, 61). In a recent case M/s Kharavela Industries Pvt. Ltd. Vs Orissa State Financial Corporation and Others (AIR 1985 Orissa 153 (A)), the question arose whether the payment made by the debtors was to be adjusted first towards the principal or interest in his absence of any stipulation regarding appropriation of payments in the loan agreement. The Court held that in the case of debt due with interest, any payment made by the debtor is in the first instance to be applied towards satisfaction of interest and thereafter towards the principal unless there is an agreements to the contrary.

Thus, the first item on the debit side will be the item to be discharged or reduced by a subsequent item on the credit side. The credit entries in the account adjust or set off the debit entries in the chronological order.

The rule derived from the Clayton’s case is of great practical significance to the bankers. In case of death, retirement or insolvency of a partner of a firm, then the existing debt due from the firm is adjusted or set off by subsequent credit made in the deceased, retired or insolvent partner and may ultimately suffer the loss if the debt cannot be recovered from the remaining partners.

Therefore, to avoid the operation of the rule given in the Clayton’s case the bank closes the old account of the firm and opens a new open in the name of the reconstituted firm. Thus the liability of the deceased, retired or insolvent partner, as the case may be, at the time of his death, retirement or insolvency is determined and he may be held liable for the same. Subsequent deposits made by surviving/solvent partners will not be applicable to discharge the same.

4. Right to Charge Interest and Commission

The Banker has an implied right to charge a reasonable commission (known as bank charges) for its services to the customer and interest on loans advanced. The right to charge interest may be either by express agreement or by banking custom. The right to charge interest ceases on the death or insolvency of the customer.

Simple, interest is paid in the case of debts due to others. But in the case of bankers unless there is an agreement to the contrary the customer has to pay interest once in a quarter. Where it is not paid in cash it will be added to the principal and it amounts to compound interest. Bankers likewise make half-yearly interest payments on the deposits they receive.

Bank charges are levied in the case of overdrafts, cash credit and current accounts but not in the case of Savings accounts. Where the customer maintains large balance in the current account, bankers waive these charges, since it is profitable to have large balances without interest.

8.7 TERMINATION OF BANKER-CUSTOMER RELATIONSHIP

Termination of the relationship between the banker and a customer could be possible by the agreement between the parties, i.e., closure of the account by the customer or by the bank. A customer can close the account without any prior notice, but the banker cannot close an account without giving a prior notice to the customer about his intentions to close the account. The account may also be closed by the operation of law. Operations in an account may come to an end by the operation of law, i.e., contrary to the intentions of the banker and the customer, the law may direct the banker not to oblige the demands of the customer. Such a situation may arise in any one of the following situations:

1. Prohibitory (Garnishee) Orders under Civil Procedure Code

Rule 46 of the Civil Procedure Code (CPC) provides that a debt shall be attached by a written order prohibiting the creditor (customer) from receiving the debt and the debtor (banker) from paying it until further order from the court. The debtor on whom such order is served is called Garnishee and the customer is called Judgement Debtor. Compliance with such orders, i.e., payment of credit balance in an account, does give a valid discharge to the banker against the customer. If the banker believes that the said credit balance cannot be appropriated under the prohibitory order, he has to show cause as to why such compliance cannot be arranged.

There are certain exceptions to this rule:

- When the debt is not actually due to the customer;
- When the money in the account is payable not only on the customer's demand, but also when he has to comply with certain conditions;
- When the account is in the joint names of judgement debtor and other persons;
- When the bank is aware that the money in the account is held by the customer as a trustee or is impressed with the trust; and
- When the bank is entitled to set-off the balance against debt owed by the judgement debtor to the bank.

2. Order for Payment under Section 226 (3) of the Income Tax Act, 1961

Section 226 (3) of the Income Tax Act, 1961 confers special powers on the Income Tax authorities for recovering the tax due from a customer out of the credit balance in his bank account. It is like a Garnishee Order but with more powers.

The Income Tax Officer can issue a notice to any person from whom money is due or may become due to the assessee, or who holds or may subsequently hold money for or on account of the assessee. The important differences between a notice under this Section (Income Tax Act) and the Garnishee Order of a Civil Court are:

- In the case of a notice from the Income Tax Authorities under Section 226 (3), the banks cannot refuse payment and refuse compliance on the plea that as per the contract the customer has to comply with certain conditions before getting his money like production of discharged FDR, etc. The conditions simply become inoperative. Payment of money to the tax authority without such compliance as well gives a valid discharge to the bank. However, in the case of Garnishee Orders, such requirements continue to be operative.
- If the assessee is a customer holding a joint account with others, the share of all the joint holders shall be presumed to be equal until the contrary is proved. Accordingly, his share must be remitted to the tax authorities. Whereas, under a Garnishee Order, such assumption cannot be made. The bank can object to the notice on two grounds: that the sum demanded is not due to the assessee; and that he does not hold any money for the assessee. This has to be intimated to the Income Tax Officer by a statement on oath.

Any claim over the money in the account, which arises after the receipt of notice by the bank, shall be void as against the demand contained in the notice. If the bank does not comply with such notice, it shall be deemed to be an assessee in default.

3. Restraining Order or Injunction from a Court

The banker can be restrained by an order of a court from honouring his customer's demands. Sometimes, the customer himself can be restrained from withdrawing money from his account. If the banker comes to know of such orders, he should stop payment on the customer's behalf.

4. Notice of Death of Customer

On the death of a customer, the title to the money in the account rests with the legal representatives and the demand of the deceased becomes ineffective. Therefore, any cheque received after the notice of the death of the customer is to be returned even if it bears a date prior to his death.

5. Lunacy of the Customer

On lunacy, a customer becomes legally incompetent to contract, and therefore, to make an effective demand. On receiving notice of such lunacy, the bank has to stop all the operations in the account of the customer.

6. Insolvency of Customer

Once a customer is declared insolvent, the relationship between the bank and the customer automatically gets terminated.

8.8 SUMMARY

The relationship between a banker and a customer depends on the activities; products or services provided by bank to its customers or availed by the customer. When customer deposits money in his account the bank becomes a debtor of the customer and customer a creditor. The banker cannot exercise his right of lien in respect of a separate account maintained by a customer which is known to the banker as a Trust Account. A banker, like other debtors, possesses this right of set-off which enables him to combine two accounts in the name of the same customer and to adjust the debit balance in one account with the credit balance in the other. If the customer overdraws any of the accounts it is considered that he is personally liable for such overdrafts and that the bank would have a right of set-off against the credit balance on his private account, the reason being that all the accounts are in the customer's name. The banker has no right to set off a deposit balance against the depositor's contingent liability on current discounted bills, but in the event of customer's insolvency, the banker has a right to set off credit balance on the account against the contingent liability on any bill he has discounted for the customer. Where a garnishee order is served in respect of a customer having more than one account in his own right, the banker has the right to first exercise the right of set-off before accounting to the judgment creditor. If the trustee in bankruptcy of a customer, who has money on deposit and also an overdraft account, claims, by presenting the deposit receipt of pass book, to have the amount of deposit paid to him leaving the bank to prove the whole amount of the overdraft, the banker can refuse to oblige the trustee and set off the deposit against the overdraft. A customer can close the account without any prior notice, but the banker cannot close an account without giving a prior notice to the customer about his intentions to close the account.

8.9 KEYWORDS

Banker: Section 5(a) of the Banking Regulation Act defines banking company as a company, which transacts the business of banking. In order to understand the nature of a banking company, one will have to look into the definition of the term ‘banking’.

Banking: Section 5(b) “Banking means the accepting for the purpose of lending or investment of deposit of money from the public, repayable on demand or otherwise and withdrawal by cheque, draft, order or otherwise”.

Customer of a bank: A customer is one who has an account with a banker or for whom a banker habitually undertakes to act as such.

Garnishee order: An order issued by the court under order 21 rules 46 of the code of civil Procedure, 1908, generally served on banks. Such order prohibits a banker from making payments from a particular a particular account named therein. When a debtor does not repay the debt owed by him to his creditor, the latter may apply to the court for the issue of a Garnishee Order on the banker of his debtor. Such order attaches the debts not secured by a negotiable instrument.

Banker as a trustee: The bankers assume the position of trustee when they accept securities or valuables from the customer for safe custody. The articles deposited with the bank for safe custody continue to be owned by the customer. The banker is to deal with the articles as per the instructions of the customer. The banker is a trustee of the customer in respect of cheques and bills deposited by the customer for collection till they are collected.

8.10 REVIEW QUESTIONS

1. "Bankers who happen to be more alert on relationship front are likely to succeed in modern times." Explain the statement and elaborate the future of bank-customer relationship in India.
2. Explain and illustrate the nature and types of bank customer's relationship in India. What is the Garnish Rule in this connection?
3. Write short notes on the following:
    a. Rights of the banker
    b. Termination of bank-customer relationship
4. Discuss the general relationship between banker and customer.

8.11 SUGGESTED READINGS

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LESSION-9 NEGOTIABLE INSTRUMENTS

STRUCTURE

9.0 OBJECTIVES

After going through this lesson, the learners will be able to know the:

- Meaning and definition of negotiable instrument.
- Characteristics of a negotiable instrument.
- Various types of negotiable instruments.
- Parties involved in negotiable instruments.
- Crossing, presentation, collection and payment of negotiable instruments.
- Dishonour and protesting of negotiable instruments.
- Protesting of negotiable instruments.
- Dishonour of negotiable instruments.

9.1 INTRODUCTION

In India, The Negotiable Instruments Act was passed in 1881. Before its approval, the provision of the English Negotiable Instrument Act was applicable in India, and the present Act is also based on the English Act with certain modifications. It extends to the whole of India except the State of Jammu and Kashmir. The Act operates subject to the provisions of Sections 31 and 32 of the Reserve Bank of India Act, 1934. Section 31 of the Reserve Bank of India Act provides that no person in India other than the Bank or as expressly authorized by this Act, the Central Government shall draw, accept, make or issue any bill of exchange, hundi, promissory note or engagement for the payment of money payable to bearer on demand. This Section further provides that no one except the RBI or the Central Government can make or issue a promissory note expressed to be payable or demand or after a certain time. Section 32 of the Reserve Bank of India Act makes issue of such bills or notes punishable with fine which may extend to the amount of the instrument. The effect or the consequences of these provisions are:

1. A promissory note cannot be made payable to the bearer, no matter whether it is payable on demand or after a certain time.

2. A bill of exchange cannot be made payable to the bearer on demand though it can be made payable to the bearer after a certain time.

3. But a cheque (-though a bill of exchange) payable to bearer or demand can be drawn on a person's account with a banker.

9.2 DEFINITION AND MEANING

Statutory Definition: According to Section 13 (a) of the Act, "Negotiable Instrument are those instrument e.g. promissory note, bill of exchange or cheque payable either to order or to bearer, whether the word "order" or " bearer" appear on the instrument or not." Justice, Willis has defined the Negotiable Instrument such as, "A negotiable instrument is one, the property in which is acquired by anyone who takes it bonafide and for value notwithstanding any defects of the title in the person from whom he took it". Thus, the term, negotiable instrument means a written document which creates a right in favor of some person and which is freely transferable. Although the Act mentions only these three instruments (such as a promissory note, a bill of exchange and cheque), it does not exclude the possibility of adding any other instrument which satisfies the following two conditions of negotiability:

1. The instrument should be freely transferable (by delivery or by endorsement and delivery) by the norms of the trade;

2. The person who receives it in good faith and for value should get it free from all imperfection, and be entitled to recover the money of the instrument in his own name. As such, documents like share warrants payable to bearer, debentures payable to bearer and dividend warrants are negotiable instruments. But the money orders and postal orders, deposit receipts, share certificates, bill of lading, dock warrant, etc. are not negotiable instruments. Even though they are transferable by delivery and endorsements, yet they are not able to give better title to the bonafide transferee for value than what the transferor has. Negotiable Instruments are essentially credit instruments with features of negotiability. Therefore, to clearly understand them one should first understand their mercantile character. Credit is the privilege to buy now and pay later. It also includes borrowing of money now with a view to pay later. Instruments which evidence or acknowledge such credits are called Credit Instruments. There are some credit instruments which are not negotiable. That is they are credit instruments but they do not have the features of negotiable. I.O.U. (l owe you) and postal order are examples of such non-negotiable credit instruments.

Of the negotiable instruments, some are negotiable under law (i.e. Negotiable Instruments Act of 1881). While the others are negotiable because of mercantile usage and custom, bills of exchange, promissory notes, and the cheques are the three instruments which are negotiable under law. A detailed discussion of the three instruments follows later, but at this stage a brief distinction between the three instruments is given. Suppose A sells his goods worth Rs. 1,000 to B on credit. The credit so allowed may be secured by means of different instruments which are given below:

1. A may draw an unconditional order on B to pay the money himself or some other specified person. Such an order is called the bill of exchange.

2. B may execute an unconditional promise to pay the money to A or his order. The instrument containing the promise is called promissory note.

3. B may draw a unconditional order on his banker (with whom he has deposited money on Current Account) to pay A or his order a sum of Rs. 1,000 only. Such an order on the banker is called a cheque.

Government of India Bonds and dividend warrants are examples of instruments which are negotiable according to usage and custom. This is so because Government of India Bonds are similar to promissory notes and dividend warrants are similar to cheques.

9.3 CHARACTERISTICS OF A NEGOTIABLE INSTRUMENT

After the knowledge of negotiable instrument, the learner must be aware about their feature. The characteristics of a negotiable instrument are as follows:

1. Property: The possessor of the negotiable instrument is supposed to be the owner of the property contained therein. A negotiable instrument does not only give ownership of the instrument but right to property also. The property in a negotiable instrument can be transferred without any regulation. In the case of bearer instrument, the property passes by mere delivery to the transferee. In the case of an order instrument, endorsement and delivery are required for the transferor property.

2. Title: The phrases ‘free from equities’ and ‘perfect title’ occur frequently in describing the rights of a holder of a negotiable instrument. Other common phrases are ‘free from all deference” or “free from defects of title”. These phrases all have the same ultimate meaning and it is important that the meaning is grasped soundly at an early stage. An equity defence or defect refers to a sustainable reason for disputing or refusing payment of the bill. If a cheque is issued for goods which prove to be defective or substandard, the drawer has grounds for stopping the cheque refusing payment. This is an equity or defence against the payee.

3. Rights: The transferee of the negotiable instrument can take legal action in his own name, in case of dishonor. A negotiable instrument can be transferred any number of times before it is at maturity. The holder of the instrument need not give notice of transfer to the party liable on the instrument to pay.

4. Presumptions: Specific presumptions are commonly apply to all negotiable instruments e.g., a presumption that consideration has been paid under it. It is not necessary to write in a promissory note the words 'for value received' or similar terminology because the payment of consideration is presumed. The words are generally included to generate additional proof of consideration.

5. On time payment: A negotiable instrument allows the holder to expect 'on time payment' because a dishonor means the damage of the credit of all persons who are evolved as a parties to the instrument.

Because of the characteristics mentioned above, negotiable instruments can pass freely from one hand to other hand. The negotiability can, however, be destroyed if it contains words to that effect as, for example, in the case of cheque crossed "Not Negotiable".

9.4 TYPES OF NEGOTIABLE INSTRUMENTS

Broadly, negotiable instruments fall under two categories as follows:

a) Negotiable Instruments by Statute: As already stated the Negotiable instruments Act states three instruments (i) Promissory notes, (ii) Bills of exchange, (iii) Cheques. Therefore these are called negotiable instruments by statute.

b) Negotiable Instruments by Custom or Usage: Some other instruments have acquired the character of negotiability by the custom or usage of trade. Section 137 of the Transfer of Property Act., 1882 also recognized that an instrument may be negotiable by law or custom. Thus, in India, (i) Hundis (ii) Share warrants (iii) Dividend warrants (iv) Bankers draft (v) Circular notes (vi) Bearer debentures (vii) Debentures of Bombay Port Trust (viii) Railway receipts (ix) Delivery orders have been developed as a negotiable by usage or custom of the trade.

9.4.1. Promissory notes

A 'promissory note' is an instrument in writing (not being a bank not or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument (Section 4)

From this definition, it is clear that a promissory note

1. It must be in writing,

2. It must contain an undertaking or promise to pay. Thus, a mere acknowledgement of indebtedness is not sufficient. Also, a receipt for money, if it does not contain express promise to pay is not a promissory note. But, if the receipt is coupled with a promise to pay, it shall be a promissory note.

3. The promise to pay must not be conditional. Thus, instruments payable on performance or non-performance of a particular act or on the happening or non-happening of an event are not promissory notes.

Example : i) A promises to pay B Rs. 5000 provided C leaves sufficient money in favour of A after C's death, is not a promissory note.

Section 4 of the Act defines, "A promissory note is an instrument in writing (note being a bank-note 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."

Essentials elements of a promissory note:

An instrument to be a promissory note must possess the following elements:

1. It must be in written form: A mere spoken promise to pay is not became a promissory note. The method of writing (either in ink or pencil or printing, etc.) does not matter, but it must be in any form that cannot be changed easily.

2. It must definitely an expressed promise to pay: There must be a clear expressed undertaking to pay. A mere acknowledgment is not enough to become a promissory note. The following are not promissory notes as there is no promise to pay.

If Y writes as:

(a) "Mr. X, I.O.U. (I owe you) Rs. 1000".

(b) "I am liable to pay you Rs. 1000".

(c) “I have taken from you Rs. 1000, whenever you ask for it I have to pay”.

The following will be taken as promissory notes because there is an express promise to pay:

If Y writes as:

(a) “I promise to pay Mr. X, Rs. 1000”

(b) “I acknowledge myself to be obliged to Mr. X in Rs. 1000 to be paid on demand, for the value received”.

(3) Promise to pay must be unconditional: A conditional undertaking eliminates the negotiable nature of a negotiable instrument. Therefore, the promise to pay must not depend upon the happening or non-happening of any outside incident or event.

(4) It should be signed by the originator: The originator must sign the instrument even though it might have been written by the promisor himself. The form or place of signatures in the instrument is not restricted. It may be anywhere in the instrument. It may be in pencil or ink, a thumb mark or initials. The pronote can also be signed by the authorized agent of the maker of the promissory note, but the agent must expressly state as to on whose behalf he has signed, otherwise he himself may be held liable as a maker.

(5) The maker of the promissory note must be definite: The note itself must clearly show the person who is agreeing to undertake the liability to pay the amount. In case a person signs in an assumed name, he is liable as a maker because a maker is taken as certain if from his description sufficient indication follows about his identity. In case two or more persons promise to pay, they may find themselves jointly or severally, but their liability cannot be in the optional.

(6) The payee must be clearly definite: The instrument must indicate with certainty the person to whom the promise has been made. The payee may be determined by name or by designation. A note payable to the maker himself is not a pronote unless it is indorsed by him. If there is a mistake in the name of the payee or in his designation; the note is valid, if the payee can be ascertained by evidence. Where, the name of a dead person is entered as payee is unaware about his death, the legal representative can enforce the performance of the instrument.

(7) The promise should be to pay money only: Money means legal tender money (Currency in circulation) and not old or rare coins/notes. A promise to carry paddy either in the substitute or in addition to money does not comprise a promissory note.

(8) The amount should be certainly defined: One of the important characteristics of a promissory note is that the amount should be certainly defined, not only regarding the person to whom or by whom payment is to be made, but also regarding the certain amount for the performance of the promissory note.

(9) Additional formalities: The additional formalities regarding number, place, date, consideration etc. usually found in the promissory notes but these are not essential in law. The date of instrument is not material unless the amount is made payable at a certain time after date. Even in such a case where, lapse of date does not invalidate the instrument and the date of execution can be determined and established.

9.4.2. Bills of exchange

Sec. 5 of Negotiable Instrument Act., 1881 defined a 'bill of exchange' as "an instrument in writing, containing an unconditional order, signed by the makers, directing a certain person to pay a certain sum of money only to or to the order of, a certain person, or to the bearer of the instruments”. This definition points out that a bill exchange should be:

1) In writing,

2) Unconditional,

3) In the form of an order not a promise or request,

4) For a sum of money, not for a sum of money, not for a commodity or anything and

5) Payable to a certain person or to his order or to the bearer of the instrument.

Therefore, a bill of exchange is a written acknowledgement of the debt, written by the creditor and accepted by the debtor. There are usually three parties to a bill of exchange drawer, acceptor or drawee and payee.

Essentials or Characteristics of Bills of Exchange

1. It must be stamped.
2. It contains an order to pay.
3. Order must be unconditional.
4. Sum payable must be certain.
5. May be drawn payable to bearer.
6. Cannot be made payable to bearer on demand.
7. Cannot be crossed like a cheque.
8. Requires acceptance by the drawee unless payable on demand.
9. It is dishonoured by non-acceptance or non-payment.
10. It may be payable by instalments.

Distinction between Promissory Note and Bill of Exchange

Promissory note differs from a bill of exchange in the following respects.

Promissory Note	Bill of Exchange
1. There are two parties, the maker (debtor) and the payee (creditor).	1. There are three parties – the drawer, the drawee and the payee.
2. A note contains an unconditional promise by the maker to pay the payee.	2. It contains an unconditional order to the drawee to pay according to the drawer's instructions.
3. No prior acceptance is needed before it is presented for payment.	3. A bill payable 'after sight' must be accepted by the drawee or his agent before it is presented for payment.
4. The liability of the maker on drawer is prime and absolute.	4. The liability of the drawer is secondary and conditional upon non-payment by the drawee.
5. Notice of dishonour need not be given to the holder to the drawer.	5. Notice of dishonour must be given by the holder to the drawer and the intermediate endorsers to hold them liable thereon.

6. The maker of the note stands in relation with the payee of promissory note.	6. The maker or drawer does not stand in intermediate relation with the payee but with the acceptor of bill of exchange.

9.4.3. Cheque

A cheque is defined as "A bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand". (Section 6 of the Negotiable Instruments Act, 1881). Thus a cheque is a bill of exchange but always drawn on a specified banker and is always payable on demand, not otherwise. A cheque is bill of exchange which should have the following two more qualifications.

(i) It is always drawn on a specified banker, and

(ii) It is always payable on demand.

Therefore, all cheques are bill of exchange, but all bills are not cheque. A cheque must satisfy all the necessities of a bill of exchange; that is, it must be signed by the drawer, and must contain an unconditional order by a specified banker to pay a certain sum of money to or to the order of a definite person or to the bearer of the cheque. But, it does not require any type of acceptance.

Difference between Bill of Exchange and Cheque

Though a cheque is defined as a bill of exchange, it differs from the latter in the following respects.

Cheque	Bill of Exchange

1. It must be drawn only on a banker	It can be drawn on any person including a banker
2. The amount is always payable on demand.	The amount may be payable on demand or after a specified time.
3. The holder of a cheque is of grace (Within this period penalties cannot be imposed)	A holder of a bill is not entitled to day to three days of grace
4. Acceptance is not needed	A bill payable after sight must be accepted
5. A cheque can be crossed.	Crossing of a bill of exchange is not possible.
6. Notice of dishonour is not necessary. The parties thereon remain liable, even if no notice of dishonour is given	Notice of dishonour is necessary to hold the parties liable thereon. A party which does not receive a notice of dishonour can generally escape is liability thereon.

9.4.4. Hundis

7. A cheque is not to be noted or protested in case of dishonour.	A bill is noted or protested to establish dishonour.

Hundis are negotiable instruments drawn by Indians in their oriental language. These are bills of exchange in tongue language. The word ‘hundi’ is said to be derived from the Sanskrit word ‘hundi’, which means “to collect”. Hundis have been in existence in India from very old days and have been recognized by law as valid and effective negotiable instruments. The Negotiable instruments Act deals with only three classes of negotiable instruments; namely, promissory note, bills of exchange and cheques. It does not govern Hundis, which are governed by custom or local usages. But where by any words in the instrument itself the usages regarding such instruments are excluded or where the writing specifically point out an purpose that the legal relations of the parties thereto shall be governed by the Negotiable instruments act, the act will apply. Hundis may be either Darshani or Muddati. Darshani hundis are payable at scene while Muddati hundis are payable after a certain period, after date of sight. The various kinds of hundis which relate to these classes are as follows.

1. Shah jog Hundi: This is a hundi payable only to a shah i.e., a respectable person or a person of worth in the market. This is the most widely used hundi in the country. Such a hundi is not payable to bearer but only to a respectable bearer.

2. Jokhmi Hundi: This is a hundi drawn against goods shipped on the boat named in the Hundi. A jokhmi hundi is designed with a purpose of to put the drawer of the hundi in funds and at the same time to affect insurance upon the goods themselves. The drawer negotiates the hundi to a broker and the broker charges a commission for his services. The broker will get the money if the vessel arrives safe in port. If the ship is lost the broker bears loss.

3. Nam jog Hundi: This is a hundi payable to named party or his order. It is similar to the shah jogs hundi, except that in place of the word shah, the name of the payee is inserted. Generally it contains a description of the person mentioned; when this is so it is not transferable.

4. Dhani jog Hundi: This is hundi payable to Dhani or owner, i.e., a person who purchases it. It is payable to any owner, holder or bearer. It is a negotiable instrument payable to bearer; where it is endorsed in full, it comes to an end to be a bearer hundi.

5. Jawabi Hundi: This is a hundi working to send money to remote places and resembles a money order. The drawer who is involved in sending the money writes to the payee and delivers the letter along with the remittance to a banker. On the payment the payee signs his receipt on the letter which is then returned to the remitter in the same way.

9.5 PARTIES TO NEGOTIABLE INSTRUMENTS

9.5.1 Parties to bills of exchange

The following are parties who are involved in a bill of exchange:

(a) The Drawer: the person who makes the bill of exchange.

(b) The Drawee: the person who is liable to pay the amount.

(c) The Acceptor: After the signed by the drawee, the person who accepts the bill. Generally, the drawee is the acceptor but an unknown person may accept it on behalf of the drawee.

(d) The payee: one to whom the sum stated in the bill is payable, either the drawer or any other person may be the payee. He is the real beneficiary under the instrument.

(e) The holder: A person who is legally allowed to the possession of the negotiable instrument in his own name and to collect the amount thereof, is called a 'holder'. The person is either the original payee or any other person to whom, the payee has endorsed the bill. In case of a bearer bill, the bearer is the holder.

(f) The endorser: When the holder of the negotiable instrument transfers the bill to anyone else he becomes the endorser.

(g) The endorsee: The person to whom the bill is transferred.

(h) Drawee in case of need: When in the bill, the name of any person is given, in addition to the drawee, to be resorted to in case of need, another person called the "drawee in case of need". The name of another person may be introduced at the option of the drawer.

(i) Acceptor for honour: Further, any person may willingly become a party to a bill as acceptor and the original drawee refuses to accept the bill or to furnish better security when demanded by the notary or to provide better security, when demanded by the notary, accept the bill supra protest in order to safeguard the honour of the drawer or any endorser, is called the acceptor for honour of the bill of exchange.

9.5.2 Parties to a Promissory Note

A promissory note has the following parties:

(a) The maker: the person who makes or executes the note promising to pay the amount stated therein.

(b) The payee: one to whom the note is payable.

(c) The holder: is either the payee or some other person to whom he may have endorsed the note.

(d) The endorser: When the holder of the negotiable instrument transfers the note to anyone else he becomes the endorser.

(e) The endorsee: The person to whom the note is transferred.

9.5.3 Parties to a cheque

The following are the parties to a cheque:

(a) The drawer: The person who draws the cheque.

(b) The drawee: The banker of the drawer on whom the cheque is drawn.

(c) The payee: one to whom the sum stated in the cheque is payable, either the drawer or any other person may be the payee.

(d) The holder: A person who is legally allowed to the possession of the negotiable instrument in his own name and to collect the amount thereof, is called a 'holder'. The person is either the original payee or any other person to whom, the payee has endorsed the cheque.

(e) The endorser: When the holder of the negotiable instrument transfers the cheque to anyone else he becomes the endorser.

(f) The endorsee: The person to whom the cheque is transferred.

9.6 CROSSING, PRESENTATION, COLLECTION AND PAYMENT OF NEGOTIABLE INSTRUMENTS

CROSSING OF CHEQUES

A cheque is an unrestricted order, drawn on a particular banker and is always payable on claim. The drawer gives particular instruction to the paying banker about the mode of disbursement of the cheque. Generally, the payee of a cheque is freely encash the cheque at the paying banker within the specified banking hours on any working day of that bank. In case of a bearer cheque, the paying banker need not ask for the identification of the holder of the cheque. Although, in the latter case, there is some risk involved. The cheque might have fallen in the hands of a wrong person. To avoid the payments made to wrong persons, the drawer may give a 'instruction' to the paying banker to pay the amount of the cheque through a banker only. Such an instruction is called a ‘crossed cheque’, without the crossing cheques are called ‘open cheques’. The crossing on a cheque is proposed to guarantee that its payment is made to the right payee of the cheque.

Type of Crossing

Broadly, Crossing on cheques can be categorize in to two types-General Crossing and Special Crossing.

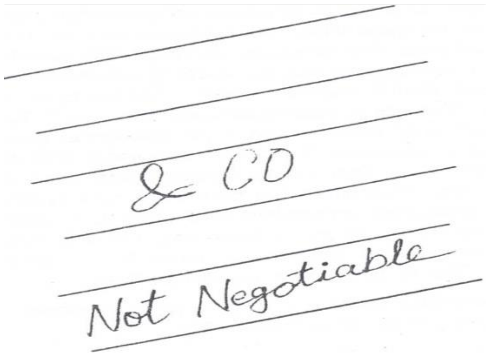
General Crossing

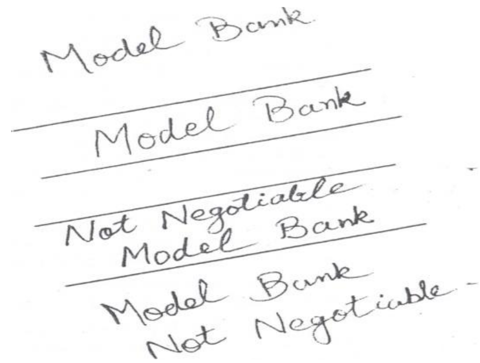
It is general crossing where a cheque bears across its face an addition of the words “and company” between two parallel sloping lines, or two parallel transverse lines simply, either with or without the words ‘not negotiable’. Where a cheque is crossed generally, the paying banker will pay to any banker. The lines must be (i) on the face of the cheque, (ii) parallel to each other, and (iii sloping lines (i.e. transverse). Inclusion of the words ‘and company’ is immaterial and of no special consequences.

In general crossing, the cheque must be presented to the paying banker and not by the payee himself at the counter.

Special Crossing

Where a cheque bears across its face an addition of the name of a banker, either with or without the words "not negotiable" that addition comprise a crossing and the cheque is considered as crossed specially and to that banker.





Specimen of a general crossing **Specimen of a special crossing**

PRESENTATION

Presentment is the process in which a negotiable instrument is submitted to the paying bank for the procurement of the instrument within its maturity period. It is only certain kind of bills of exchange that need presentment for acceptance. A bill payable 60 days after due date on the happening of a certain event may or may not be presented for acceptance. But the following bills must be presented for acceptance, otherwise, the parties to the bill will not be liable for the performance:

(a) A bill payable after sight. Presentment is necessary in order to fix maturity of the bills; and

(b) A bill in which there is an express condition that it shall be presented for acceptance before it is presented for payment.

Section 15 of the Negotiable Instrument Act, provides that the "presentment for acceptance must be made to the drawee or his duly authorized agent. If the drawee has been expired (dead), the bill should be presented to his legal representative, or if he has been declared an bankrupt, to the official receiver or assigner".

The following are the persons to whom a bill of exchange should be presented:

(i) The drawee or his duly approved agent.

(ii) If there are many drawees, bill must be presented to all of them.

(iii) The official receiver or assignee of insolvent drawee.

(iv) The legal representatives of the drawee when drawee is dead.

(v) To a drawee in case of need, when the original drawee refuses to accept the bill.

(vi) The acceptor for honor. In case the bill is not accepted and is noted or protested for non-acceptance, the bill may be accepted by the acceptor for honor.

The presentment must be made before the maturity of the instrument, within a reasonable time after it is drawn, or within the fixed period, if any, on a business day within business hours and at the place of business or residence of the drawee. The presentment must be made by display the bill to the drawee; simple notice of its existence in the ownership of holder will not be adequate.

Presentment for Payment

Negotiable instruments e.g., all notes, bills and cheques must be presented for payment to the creator, acceptor or its drawee correspondingly by or on behalf of the holder during the normal hours of business, and if at banker's within banking hours of the concerned bank.

Presentment for Acceptance when Excused

Compulsory presentment for acceptance is excused and the bill may be treated as dishonored in the following cases:

(a) Where the drawee cannot be found after reasonable search.

(b) Where drawee is a fake person or one unable of contracting.

(c) Where the presentment is irregular, acceptance has been rejected in some cases.

Presentment for Payment when Excused

Presentment is not required and the instrument may be treated as dishonored in the following cases:

(a) Where the maker, drawer or acceptor actively does something so as to intentionally obstruct the presentment of the instrument, e.g., deprives the holder of the instrument and keeps it after maturity.

(b) Where his business place is closed on the due date.

(c) Where no person is present to make payment at the place specified for payment.

(d) Where he cannot, after due search be found.

(e) Where there is a guarantee to pay in spite of non-presentment.

(f) Where the presentment is impliedly waived by the party entitled to presentment.

(g) Where the drawer could not possibly have suffered any damage by non-presentment.

(h) Where the drawer is a fake person, or one incompetent to contract.

(i) Where the drawer and the drawee are the same person.

(j) Where presentment has become not possible, e.g., the announcement of war between the countries of the holder and drawee.

(k) Where though the presentment is irregular, acceptance has been refused in some grounds.

9.7 DISHONOUR AND PROTESTING OF NEGOTIABLE INSTRUMENTS

9.7.1 PROTESTING OF NEGOTIABLE INSTRUMENTS

When a negotiable instrument is dishonoured the holder may go to court against his prior parties i.e. the drawer and the endorsers after he receiving a notice of dishonour to them. The holder may need a valid proof of the fact that a negotiable instrument has been dishonoured. When a cheque is dishonoured, the bank that refuses the payment and returns back the cheque by explaining the reasons in writing. Sections 99 and l00 of Negotiable Instrument Act provide suitable methods of validated fact of dishonour of a bill of exchange and promissory note by means of ‘protest’.

Protesting

Protest is an appropriate certificate of the notary public attesting the dishonour of the bill by non-acceptance or by non-payment. The chief benefit of protest is that the court shall presume the fact of dishonour on proof of the protest. Beside the protest for non-acceptance and for non-payment the holder may protest the bill for the safety. When the acceptor of a bill turns into bankrupt or suspends payment before the date of maturity, or when he break out the holder may protest it in order to obtain better security for the amount owing. For this reason the holder may occupy a notary public to make the demand on the acceptor and if refused, protest may be made. When promissory notes and bills of exchange are required to be protested, notice of protest must be given in place of notice of dishonour. Where a bill is required to be protested under the Act within a particular time, it is enough if it is 'noted for protest' within such time. The formal protest may be given at any time after the noting.

Contents of protest

Section 101 of the Negotiable Instrument Act describes the contents of a regular and ideal protest which are as follows:

1. The instrument itself or an accurate transcript of the instrument; and of the whole thing written or printed.

2. The person's name for whom or against whom the instrument has been protested.

3. The fact of and reasons for dishonour of the instrument

4. The time and place of demand and dishonour.

5. The signature of the notary public.

6. In the case of acceptance for honour or payment for honour the person by whom or for whom such reception or payment was obtainable and affected.

9.7.2 DISHONOUR OF NEGOTIABLE INSTRUMENTS

A promissory note, bill of exchange or cheque is said to be dishonoured by non-payment when the maker of the note, acceptor of the bill or drawee of the cheque makes default in payment upon being duly required to pay the same. As against section 91, section 92 applies to all the three types of instruments, namely, promissory notes, bills of exchange and cheques. When the maker of a note, or an acceptor of a bill of exchange, or a drawee in case of need, or an acceptor of a bill (supra) protest or a banker to whom a cheque is drawn fails and neglects to pay the amount against the instrument according to the apparent tenor thereof when presented to him on the due date, the dishonour is complete.

a) NECESSITY FOR NOTICE

In the case of dishonour by non-acceptance, so also in that of dishonour by non-payment, notice of dishonour must be given to the drawer and each endorser; otherwise the drawer of any to endorser to whom such notice it not given is discharged. But where a bill has been dishonoured by non-acceptance, and due notice of dishonour has been given it is unnecessary to give notice of a subsequent dishonour by non-payment unless the bill has in the meantime been accepted. The rules for giving due notice of dishonour are the same whether the dishonour has been by non-acceptance or non-payment.

The rules relating to the notice of dishonour to be given as follows:-

(A) Notice must be given by or on behalf of the holder, or by on behalf, of an endorser who, at the time of giving the notice, is himself liable on the bill. Thus the holder, on dishonour, may give notice of it to any previous endorser or endorsers who, in their turn may serve notice to those, whom they would like to hold responsible. Notice may be given by the agent either in his own name, or in the name of any party entitled to give notice.

(B) Where the notice is given by or on behalf of the holder, it ensures for the benefit of all subsequent holders and all prior endorsers, who have a right of recourse against all parties to whom it is given. Thus A, B, C, D and E are endorsers. F is the holder; if F give a notice to A of the dishonour, it ensures for the benefit of B,C,D and E as they have themselves a right of recourse against A.

(C) When notice is given by or on behalf of the endorser, it ensures for the benefit of the holder and all endorsers subsequent to the party to whom notice is given.

Notice may be given to the party himself or his agent in that behalf. If the drawer of endorser is dead, and the party giving notice knows it, it must be given to his legal representative if he could be reasonably found. If the drawer or endorser is a bankrupt, notice may be given to him or his official assignee. If there are two or drawers or endorsers who are not partners notice must be given to each of them, unless one of them has authority to receive such notice for the others.

b) PARTICULARS TO BE STATED IN NOTICE

The plaintiff (the person who complain) is based on a negotiable instrument where he is the endorsee must state clearly in his plaint (complain) that a notice of dishonour was sent to the endorser and must give the particulars thereof or where he considers that he is exempt from giving this notice, he should allege the facts which exempt him from giving such notice. The notice may be oral or written but it is necessary that it must have been given within a reasonable time. The notice must also clearly estimate that payment was demanded from the drawee but refused and that the holder holds the person notified liable on the instruments. The importance of this requirement lies in the consideration that the giving of a notice of dishonour is a part of plaintiff's cause of action and is a condition precedent for making the endorsee liable and in the absence of such a notice, his liability to the endorsee must stand extinguished. Where the endorsee of a pronote seeks to make the endorser liable, the fact of presentment and issue of notice of dishonour should be made clear in the plaint itself, as notice of dishonour has been held to be a material part of the cause of action where there is no such allegation in the plaint, nor is there any proof of the same, the endorsee of a simple on demand pronote will not be entitled to a decree against an endorser.

Wherein a suit on a promissory note payable at a specified place, the plaint contains no allegation or presentment, plaintiff cannot be given an opportunity of proving presentment.

c) NECESSITY OF NOTICE OF DISHONOUR

If notice of dishonour was necessary in every case where any type of bill of exchange had been dishonoured, it was not necessary at all to enact sections 91 to 93. Section 30 itself had provided for a notice of dishonour and it would have been quite enough for the aforesaid purpose. After a good deal of consideration of the various aspects, the following conclusions arise:-

(A) that a bill of exchange payable after sight is required by law to be presented for acceptance and if it is dishonoured on being presented, the provisions of section 91 and 93 are attracted and a notice of dishonour becomes essential;

(B) that a bill of exchange payable on a fixed date is not required by law to be presented for acceptance, but may at the option of the holder be presented for acceptance at any time earlier than the date fixed for its payment. If it is presented for acceptance and it is dishonoured, a notice of dishonour becomes essential;

(C) that a bill of exchange payable at sight is not required by law to be presented for acceptance only but when presented for payment, it must be deemed to have been presented both for acceptance and payment. On its being dishonoured the provisions of sections 91 to 93 of the Act would become applicable and a notice of dishonour under the said provisions will become essential; and

(D) that section 30 of the act is not a complete code in itself in regard to bills of exchange of every type. It only deals with the liability of the drawer and the words “as hereinafter provided” in the said section must be interpreted to mean as provided by section 92 and 93 of the Act.

Section 94 of the Negotiable Instruments Act speaks of the modes in which notice has to be given and notice by post is a perfectly legal method by which notice can be given. Proviso (b) to section 138 of the Act insists that the said notice should be in writing; and the liability under section 138 of the act would arise only if the accused defaulted payment within 15 days of the “receipt” of notice. This has got special significance; only if the person accused of the offence knows as to the dishonour can he pay the amount within the stipulated time.

d) PROCEDURE OF NOTICE

Section 138 of the Amended Act provide, both for punishment of imprisonment and fine both alternatively with imprisonment or fine as the case may be, yet, the working of the section is governed by the three provisos to the Section which may be termed as the regulating and controlling factors. In case any of the basic requirements is not fulfilled and in case any particular case is hit by non-compliance to the condition specified therein, a person cannot be prosecuted under Section 138 of the Act. These provisos have been in brief as under:

Clause (b) of the proviso of Section 138 states that the payee or the holder in due course of the cheque makes a demand by giving a notice within 15 days of the receipt of information by him regarding the dishonour of the cheque. Now the period of 15 days has been increased to that of 30 days by the Amendment Bill No. 55 of 2002. In this way this proviso stipulates –

a) The payee is the holder in due course.

b) A demand is made by giving a notice by the payee to the drawer.

c) The notice is given within a period of 15 days (now 30 days as per new provisions) from the date of receipt of the information about dishonour.

The provision of a notice in the proviso (b) to Section 138 of the Act has been enacted so as to give an opportunity to the person who has drawn the cheque to make the payment. In case there is no *mala fide* on his part. What is contemplated by the section is a 'notice in writing'.

A. Written Form -

The Clause (b) of proviso to Section 138 of the Negotiable Instruments Act, 1881 contemplates 'notice in writing'. It does not say that is should be sent by Registered Post or that is should be served by post. The Section 27 of the General Clauses Act cannot be transposed into Section 138 of the Negotiable Instruments Act, where the 'service by post' is not contemplated and what is contemplated is 'notice in writing.'

B. Proper Address –

Where the notice, which was sent to the accused, returned with endorsement 'not found' and the complainant immediately went to the business place of the accused to deliver notice, which was refused, it was held that notice sent at proper address amounts to constructive notice. This is a notice which was sent by the complainant by the Registered Post for the purpose of Section 138 of the Negotiable Instruments Act and which was returned with the endorsement 'unclaimed'. This shall be sufficient service for the purpose of the Act and shall amount to a culpable default or deliberate evasion of the accused. This would constitute 'receipt of notice'.

The Delhi High Court has held that the receipt of notice by even a partner habitually working for the business of the Firm operates as a notice to the firm. In case a notice is issued to a firm then there is no question of issuing a notice to all the partners. Whereas the Allahabad High Court has held that if there is no notice, there is no offence and thus the notice is must.

In the case the notice is refused, the cause of action is the date of refusal and file the complaint within 15 days of the refusal of the notice.

The Calcutta High Court has held that in case of offence by the Company, no separate notice under clause (b) of proviso to section 138 is required to the Director of the Company.

e) Obligations under Section 138 of Negotiable Instruments Act, 1881 –

To constitute an offence under Section 138 of the Negotiable Instruments Act, 1881, the Complainant is obliged to prove its ingredients which include the 'receipt of notice' by accused under clause (b). It is to be kept in mind that it not the 'giving of notice' which makes the offence, but is the 'receipt' of the notice by the drawer which gives cause of action to complainant to file the complaint within the statutory period.

It is settled law that without taking peremptory action in exercise of his right under clause (b) of Section 138 of the Negotiable Instruments Act, 1881, the payee cannot go on presenting the cheque so as to enable him to exercise his right at any point of time during the validity of the cheque. But once he gives a notice under clause (b) of the proviso to Section 138 of the Act, he forfeits the right of presenting the cheque all over again, for, in the case of failure of drawer to pay the money within the stipulated time, the drawer would be liable for the offence and the cause of action for filing the complaint will arise with the period of one month for filing the complaint being required to be reckoned from the day immediately following the day on which the period of fifteen days from the date of the notice by the drawer expires.

Statutory notice of demand must be a written notice and not an oral notice. When the complainant brought fact of dishonour of Cheque to notice of accused orally but on request by accused, complainant allowed three months time. On second presentation, cheque was again dishonoured. Statutory Notice after second dishonour by complainant was well within validity period then complaint filed after second dishonour within validity period was proper.

f) WHEN NOTICE OF DISHONOUR IS UNNECESSARY – NO NOTICE OF DISHONOUR IS NECESSARY – (SECTION 98)

(A) When it is dispensed with by the party entitled thereto; Notice of dishonour is dispensed with altogether where despite the exercise of reasonable diligence it cannot be given to or does not reach the drawer or endorser whom it is sought to charge. In the case of Promissory note which is not negotiable, notice is not necessary.

(B) In order to charge the drawer, when he has countermanded payment. It is not necessary that the actual words "Countermanding payment", should be used; it is sufficient if the words used clearly show that the drawer does not want payment to be made in accordance with the tenor of the hundi. The question of countermanding payment is a question of fact.

(C) When the party charged could not suffer damage for want of notice; when from the conduct of a company, it is apparent that they were aware of the liability, the case is covered by section 98(C) which provides that no notice of dishonour is necessary when the party charged could not suffer damage for want of notice.

(D) When the party entitled to notice cannot after due search be found; or the party bound to give notice is, for any other reason, unable without any fault of his own to give it; Notice of dishonour to the minors is not necessary.

(E) To charge the drawers, when the acceptor is also a drawer; Section 98(e), N.I. Act makes it quite clear that no notice of dishonour is necessary to charge drawees when acceptor is also a drawer. The use of singular "drawee" followed by plural "drawees" in section 98 shows that if a acceptor is one of the drawers, both the drawers would be liable even though no notice of dishonour has been given.

(F) In the case of a promissory note which is not negotiable; where the payee has endorsed pronote to another person after it barred by limitation and with fabricated endorsement of payment, there is no necessity to give notice of dishonour to the endorser.

(G) When the party entitled to notice, knowing the facts, promises unconditionally to pay the amount due on the instrument under section 98(g) of the Negotiable Instruments Act, when a party entitled to notice, knowing the facts, promises unconditionally to pay the amount, due on the instrument, the notice of dishonour is not necessary. The promise to pay contemplated by section 98(g) may be either express or implied. If a

person unequivocally acknowledges that a debt is due from him, he should be taken impliedly to promise to pay it. He may couple his acknowledgement with some expression which shows that he was not promising to pay; but if there is no such qualification, the acknowledgement of the debt involves an implied promise to pay.

(H) As regard the drawer the notice of dishonour is dispensed within the following cases:- (i) when the drawer and the drawee are the same person; (ii) when the drawee is a fictitious person, or non-existing person; (iii) When the drawee is a person not having capacity to contract, (iv) where the drawer is the very person to whom the bill is presented for payment (v) where the drawee or acceptor is, as between himself and the drawer, under no obligation to accept or pay the bill; (vi) where the drawer has countermanded payment.

9.8 SUMMARY

A negotiable instrument is a piece of paper which entitles a person to a sum of money and which is transferable from one person to another by mere delivery or by endorsement and delivery. The characteristics of a negotiable instrument are easy negotiability, transferee gets good title, transferee gets a right to sue in his own name and certain presumptions which apply to all negotiable instruments. There are two types of negotiable instruments (a) Recognised by statue: Promissory notes, Bill of exchange and cheques and (b) Recognised by usage: Hundis, Bill of lading, Share warrant, Dividend warrant, Railway receipts, Delivery orders etc. The parties to bill of exchange are drawer, drawee, acceptor, payee, indorser, indorsee, holder, drawee in case of need and acceptor for honour. The parties to a promissory note are maker, payee, holder, indorser and indorsee while parties to cheque are drawer, drawee, payee, holder, indorser and indorsee. Negotiation of an instrument is a process by which the ownership of the instrument is transferred by one person to another. There are two methods of negotiation: by mere delivery and by endorsement. In its literal sense, the term 'indorsement' means writing on an instrument but in its technical sense, under the Negotiable Instrument Act, it means the writing of a person's name on the face or back of a negotiable instrument or on a slip of paper annexed thereto, for the purpose of negotiation. A bill may be dishonoured by non-acceptance (since only bills require acceptance) or by non-payment, while a promissory note and cheque may be dishonoured by non-payment only. Noting means recording of the fact of dishonour by a notary public on the bill or paper or both partly. Protest is a formal notarial certificate attesting the dishonour of the bill. The term 'discharge' in relation to negotiable instrument is used in two senses, viz., (a) discharge of one or more parties from liability thereon, and (b) discharge of the instrument.

9.9 KEYWORDS

Negotiable instrument: A negotiable instrument is one, the property and the title in which is acquired by anyone who takes it as bonafide and for value notwithstanding any defect in the title of the person from whom he/she took it.

Promissory note: A promissory note is an instrument in writing (not being a bank note or 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.

Bills of exchange: A bill of exchange is 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 to the bearer of the instrument.

Accommodation bills: Those bills, which are drawn without any actual consideration, merely, to help out friends and relatives are known as accommodation bills.

Banker's draft: It is a bill of exchange in which a bank orders its branch or another bank, as the case may be, to pay a specified amount to a specified person or to the order of the specified person.

Cheque: Cheque is a kind of bill of exchange, which is always drawn upon a specific bank and is payable on demand.

Crossing of a cheque: When two angular parallel lines are drawn on the face of the cheque, then the cheque said to be crossed.

Usances: The time fixed by the custom of countries for payment of bills drawn in one country but are payable in another country is known as a usance.

Payment in due course: Payment in due course means payment of the instrument after the expiry of the duration of the instrument, in good faith and without any negligence, to the possessor thereof and

without the existence of any circumstances that may lead one to believe that the person receiving the payment is not entitled to it.

Assignment: Assignment of any object means the transfer of its tile to another person through a written and registered deed under the Transfer of Property Act.

9.10 REVIEW QUESTIONS

1. What is meant by negotiation? How is it effected and how does it differ from an assignment?
2. Define endorsement. What are the various classes of endorsement?
3. Explain the privileges granted to a holder in due course.
4. In what different ways may a negotiable instrument be dishonoured? What are the duties of a holder of a dishonoured bill?
5. How and when should a notice be served on a bill being dishonoured by either non-acceptance or non-payment? Under what circumstances is notice of dishonor unnecessary?
6. What are the various ways in which one or more parties to a negotiable instrument is/are discharged for liability? Discuss.
7. Define the term ‘negotiable instrument’. What are its essential characteristics?
8. Discuss the presumptions in respect of a negotiable instrument.
9. What is a bill of exchange? How does it differ from a promissory note.

10. Who are the parties to a negotiable instrument? Discuss.

9.11 SUGGESTED READINGS

• Avtar Singh: Law of Contract; Eastern Book Co., Lucknow.

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LESSON-10 BANKERS CLEARING HOUSE

STRUCTURE

10.0 OBJECTIVES

After going through this lesson, the learners will be able to know the:

- Definition and meaning banker's clearing system, clearing houses and clearing members.
- Banker's clearing system of negotiable instrument and security market in India.
- Main functions of clearing house.
- Clearing process for various instruments.
- Clearing house and e-payment in India.
- Regulation of clearing houses in India through various regulatory authorities.

10.1 INTRODUCTION

There is a no doubt that the clearing system is a significant example of evolution in the financial system. It was not suddenly created, but it is the result of an ongoing development brought about as a necessity to meet the requirements of the times. Indeed its development all through has been due to forces from without rather than from within. The growth of banking accommodation has demanded that an institution such as the Bankers' Clearing House should always be in a position to meet the necessity of the current age, and it has never failed. There will be shown at a later stage many examples of how at the psychological moment new duties have been imposed, and of the efficient manner in which these duties have been carried out. The steady increase of the bankers' cheque was the force which first impelled the conception of a Clearing and pioneers of the existing system.

It will be well to outline briefly what the clearing system is and the service it renders to the community. Its primary object is the collection of drafts payable between banker and banker, and the consolidation as far as possible of the necessary transfer of currency in the settlement of all such collections. The crude method of numerous cross presentations and the consequent waste of currency is superseded and focused into single transfers by the individual banks embracing the whole of the members of the Clearing. This is accomplished by making exchanges at a given centre and totaling the debit and credit sides of the account, striking a balance, and then determining the amount due to pay or receive to or from the collective banks. It is also a means of rapid collection and the passing of cheques to the debit and to the credit of banks' customers as quickly as possible, thus fulfilling a service of great importance to merchants and others.

10.2 DEFINITION AND MEANING

When a customer is permitted to withdraw the money through cheque the banks are put in a position to collect/Pay and process the customer's cheque. The banks which honour the cheque of the customer and pay the money on behalf of the customers are called as paying banker. The bank which helps in collecting the cheque is called as collecting banker. When the place of paying bank and collecting bank are the same the collection process is simple. But when cheques are tendered for collection by customers at a branch in a city, which is not the actual place of the drawee branch. These are called outstation cheques and these cheques typically take longer realization periods. This process may take up to 10 days. Processing of paper based cheques constitutes an important segment of the payment and settlement scenario of the India. Settlement of cheques is arrived on the basis of the physical presentation of paper based cheques to the clearing houses of the country for transmission to the drawee banks and for payment thereafter. RBI manages 16 clearing houses, SBI Group manages more than 1000 clearing houses and a few other public sector banks, also manage the clearing houses. The banks managing the clearing houses also act as the settlement banks.

10.3 BANKER'S CLEARING SYSTEM IN INDIA

In India, the clearing system is local and confined to a defined jurisdiction covering all the banks and branches situated in the area under a particular region. The clearing house is a voluntary association of banks under the management of a bank where the settlement accounts are maintained. Wherever Reserve Bank of India has its office (and a banking department), the clearing house is managed by it. In the absence of an office of the Reserve Bank, the clearing house is managed by the State Bank of India, its associate banks and in a few cases by public sector banks.

In India there are about 1050 cheques clearing houses. These clearing houses clear and settle transactions relating to various types of paper based instruments like cheques, drafts, payment orders, interest / dividend warrants, etc. In 40 of these clearing houses, cheque processing centers (CPCs) using MICR (Magnetic Ink Character Recognition) technology have been set up. At 14 more clearing houses, MICR cheque processing systems are proposed to be set up. The Reserve Bank has issued the Uniform Regulations and Rules for Bankers' Clearing Houses (URRBCH) which have been adopted by all the clearing houses. These regulations and rules relate to the criteria for membership / sub-membership, withdrawal / removal / suspension from membership and the procedures for conducting of clearing as well as settlement of claims between members.

10.3.1 FUNCTIONS OF CLEARING HOUSE

Clearing Corporation to maintain Clearing House

The Clearing Corporation shall maintain a Clearing House which shall function as per the instructions and supervision of the relevant authority or such other relevant authority as may be specified from time to time. The Clearing House shall act as the common agent of the clearing members and for delivering securities to and receiving securities from such members in connection with any of the deals and to do all things necessary or proper for carrying out the foregoing purposes.

Clearing House to deliver Securities at discretion

Subject to the above, the Clearing House is entitled at its discretion to deliver securities which it has received from a clearing member under these Regulations to another clearing member who is entitled under these Regulations to receive delivery of securities of a like kind or to instruct a clearing member to give direct delivery of securities which he has to deliver.

Release of Intermediaries

If a clearing member delivers securities outside the Clearing House except when so provided in these Regulations or so directed by the relevant authority, making and accepting such delivery shall release all intermediate parties from all liabilities. The deliverer shall alone remain responsible to the receiver.

Authority to Pledge

The relevant authority shall have the right to borrow money against and pledge all or any part of the securities held by the Clearing House for the account of any member who fails to pay all or part of funds to be paid on the pay-in day.

Selling-Out

The securities not taken up and paid for shall be sold-out by the Clearing Corporation in accordance with the Bye Laws and Regulations relating to closing out.

Clearing Assistants for the Clearing House

A clearing member may nominate two or more clearing assistants as may be specified by the relevant authority from time to time, who shall be competent to sign on behalf of such clearing member all clearing forms, vouchers, claim notes, receipts and other documents and transact on his behalf all such business as is necessary to be transacted in all matters connected with the operations of the Clearing House. Each clearing assistant shall be issued an Identity Card which shall be displayed by him on his person during his presence at the Clearing House premises.

Attendance at Clearing House

A clearing member who has to give or take delivery of securities, transfer deed or any other documents or to make or accept payments shall either attend personally in the Clearing House or be represented by his clearing assistant at the proper time and no clearing member shall be entitled to demand delivery of securities, transfer deeds or any other documents outside the Clearing House unless other-wise permitted by the relevant authority .

Specimen Signatures

A clearing member shall file with the Clearing House specimens of his own signature and of the signatures of his Clearing Assistants. The specimen signature card shall be signed by the clearing member and his Authorized Representative in the presence of an officer of the Clearing Corporation or of the Clearing House.

Comparison with Specimen Signatures when Necessary

When handing over securities the Clearing House shall compare the signature appearing on the acknowledgment receipt with the specimen signature in its possession. In the case of any other Clearing Forms, the Clearing House may make such comparison in its entire discretion but it shall be under no obligation to do so nor shall it in any manner incur any liability by reason of having done or omitted to do so.

Clearing House Split and Balance Receipts

The Clearing House Split and Balance Receipts shall be in the form prescribed in the relative Regulation or in such other form or forms as the relevant authority may from time to time prescribe in addition thereto or in modification or substitution thereof.

10.4 CLEARING PROCESS FOR VARIOUS INSTRUMENT

10.4.1 Clearing and Settlement Process for security market instrument

While NSE provides a platform for trading to its trading members, the National Securities Clearing Corporation Ltd. (NSCCL) determines the funds/securities obligations of the trading members and ensures that trading members meet their obligations. NSCCL becomes the legal counterparty to the net settlement obligations of every member. This principle is called `**novation**' and NSCCL is obligated to meet all settlement obligations, regardless of member defaults, without any discretion. Once a member fails on any obligations, NSCCL immediately cuts off trading and initiates recovery.

Clearing Process

Determination of Obligation: NSCCL determines what counter-parties owe and what counter-parties are due to receive on the settlement date. The NSCCL interposes itself as a central counterparty between the counterparties to trades and nets the positions so that a member has security wise net obligation to receive or deliver a security and has to either pay or receive funds. At the end of each trading day, concluded or locked-in trades are received from NSE by NSCCL. NSCCL determines the cumulative obligations of each member and electronically transfers the data to Clearing Members (CMs). This implies that all trades concluded during a particular trading period are settled together. A multilateral netting procedure is adopted to determine the net settlement obligations (delivery / receipt positions) of CMs. NSCCL then allocates or assigns delivery of securities inter se the members to arrive at the delivery and receipt obligation of funds and securities by each member.

Settlement Process

The settlement process begins as soon as member's obligations are determined through the clearing process. The clearing banks and depositories provide the necessary interface between the custodians/clearing members (who clear for the trading members or their own transactions) for settlement of funds/securities obligations of trading members. The clearing corporation provides a major link between the clearing banks, clearing members and the depositories. This link ensures actual movement of funds and securities on the prescribed pay-in and payout

day. The core processes involved in the settlement process are:

(i) Pay-in of Funds and Securities: The members bring in their funds/securities to the NSCCL. They make available required securities in designated accounts with the depositories by the prescribed pay-in time. The depositories move the securities available in the accounts of members to the account of the NSCCL. Likewise members with funds obligations make available required funds in the designated accounts with clearing banks by the prescribed pay-in time. The NSCCL sends electronic instructions to the clearing banks to debit member's accounts to the extent of payment obligations. The banks process these instructions, debit accounts of members and credit accounts of the NSCCL.

(ii) Pay-out of Funds and Securities: After processing for shortages of funds/securities and arranging for movement of funds from surplus banks to deficit banks through RBI clearing, the NSCCL sends electronic instructions to the depositories/clearing banks to release pay-out of securities/funds. The depositories and clearing banks debit accounts of NSCCL and credit settlement accounts of members. Settlement is complete upon release of pay-out of funds and securities to custodians/members. Settlement is deemed to be complete upon declaration and release of pay-out of funds and securities. Exceptions may arise because of short delivery of securities by CMs, bad deliveries or company objections on the pay-out day. (The detailed explanation of securities and funds settlement follows in the later section). NSCCL identifies short deliveries (discussed later) and conducts a buying-in auction on the day after the pay-out day through the NSE trading system. The delivering CM is debited by an amount equivalent to the securities not delivered and valued at a valuation price (the closing price as announced by NSE on the day previous to the day of the valuation). If the buy-in auction price is more than the valuation price, the CM is required to make good the difference. All shortages not bought-in are deemed closed out at the highest price between the first day of the trading period till the day of squaring off or closing price on the auction day plus 20%, whichever is higher. This amount is credited to the receiving member's account on the auction pay-out day. The settlement process for transactions in securities in the CM segment of NSE is presented in the Figure.

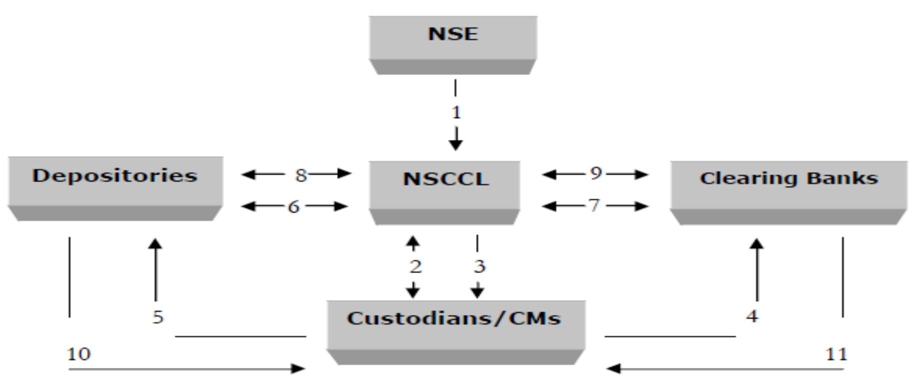

Figure: Settlement Process in CM segment of NSE

Explanation:

(1) Trade details from Exchange to NSCCL (real-time and end of day trade file).

(2) NSCCL notifies the consummated trade details to CMs/custodians who affirm back. Based on the affirmation, NSCCL applies multilateral netting and determines obligations.

(3) Download of obligation and pay-in advice of funds/securities.

(4) Instructions to clearing banks to make funds available by pay-in time.

(5) Instructions to depositories to make securities available by pay-intime.

(6) Pay-in of securities (NSCCL advises depository to debit pool account of custodians/CMs and credit its account and depository does it).

(7) Pay-in of funds (NSCCL advises Clearing Banks to debit account of custodians/CMs and credit its account and clearing bank does it).

(8) Pay-out of securities (NSCCL advises depository to credit pool account of custodians/CMs and debit its account and depository does it).

(9) Pay-out of funds (NSCCL advises Clearing Banks to credit account of custodians/CMs and debit its account and clearing bank does it). (10) Depository informs custodians/CMs through DPs.

(11) Clearing Banks inform custodians/CMs.

Settlement Cycle

Settlement cycles for securities in dematerialized and physical mode are explained below:

Settlement Cycle for Dematerialized Securities

(i) Normal Market: The trades executed each trading day are considered as a trading period and trades executed during the day are settled based on the net obligations for the day. At NSE, trades in rolling settlement are settled on a T+2 basis i.e. on the 2nd working day. Typically trades taking place on Monday are settled on Wednesday, Tuesday's trades settled on Thursday and so on. A tabular representation of the settlement cycle for rolling settlement is given below

in Table:

Table: Settlement Cycle – Normal Market

	Activity	Day
Trading	Rolling Settlement Trading	T
Clearing	Custodial Confirmation	T+1 working days
	Delivery Generation	T+1 working days
Settlement	Securities and Funds pay-in	T+2 working days
	Securities and Funds pay-out	T+2 working days
	Valuation of shortages based on closing prices (at T+1 closing prices)	T+2 working days
Post Settlement	Auction	T+2 working days
	Auction settlement	T+3 working days
	Bad Delivery Reporting	T+4 working days
	Rectified bad delivery pay-in and pay-out	T+6 working days
	Re-bad delivery reporting and pickup	T+8 working days
	Close out of re-bad delivery and funds pay-in & pay-out	T+9 working days

(ii) Inter Institutional Deals: Trading in this market segment is available for 'institutional investors' only. In order to ensure that the overall FII limits are not violated, selling in this segment is restricted to FII clients. Buying is restricted to Institutional clients. Members are required to enter the custodian participant code at the time of order entry and to ensure that the selling/buying restrictions are strictly adhered to. A sale order entered by trading members on behalf of non FII clients or a buy order entered by trading members on behalf of non institutional (FII, FI, Banks, Mutual Funds & Insurance Companies) clients, is deemed to be invalid. The member entering the invalid order is further liable for disciplinary action, which may include penalties, penal action, withdrawal of trading facilities, suspension etc. Deals executed in this segment are cleared on a T+2 rolling basis. Settlement of all transactions is compulsorily in demat mode only. The settlement cycle for this segment is shown below in Table below:

Table : Settlement Cycle – Inter Institutional Deals

	Activity	Day
Trading	Rolling Settlement Trading	T
Clearing	Custodial Confirmation	T+1 working days
	Delivery Generation	T+1 working days
Settlement	Securities and Funds pay-in	T+2 working days
	Securities and Funds pay-out	T+2 working days
	Valuation of shortages based on closing prices	at T+1 closing prices
Post Settlement	Close out	T+2 working days

Settlement Cycle for Physical Securities

Limited Physical Market: For limited physical markets, settlement for trades is done on a trade-for-trade basis and delivery obligations arise out of each trade. Salient features of Limited Physical Market settlement are:

(a) Delivery of shares in street name and market delivery (clients holding physical shares purchased from the secondary market) is treated as bad delivery. The shares standing in the name of individuals/HUF only would constitute good delivery. The selling/delivering member must necessarily be the introducing member.

(b) Any delivery of shares which bears the last transfer date on or after the introduction of the security for trading in the LP market is construed as bad delivery.

(c) Any delivery in excess of 500 shares is marked as short and such deliveries are compulsorily closed-out.

(d) Shortages, if any, are compulsorily closed-out at 20% over the actual traded price. Unrectified bad delivery and re-bad delivery are compulsorily closed-out at 20% over the actual traded price.

(e) All deliveries are compulsorily required to be attested by the introducing/ delivering member.

(f) The buyer must compulsorily send the securities for transfer and dematerialization, latest within 3 months from the date of pay-out.

(g) Company objections arising out of such trading and settlement in this market are reported in the same manner as is currently being done for normal market segment. Securities, however, would be accepted as valid company objection, only if the securities are lodged for transfer

within 3 months from the date of pay-out. The settlement cycle for this segment is same as for the rolling settlement, as shown in Table below:

Table: Settlement Cycle – Physical Securities

	Activity	**Day**
Trading	Rolling Settlement Trading	T
Clearing	Custodial Confirmation	T+1 working days
	Delivery Generation	T+1 working days
Settlement	Securities and Funds pay-in	T+2 working days
	Securities and Funds pay-out	T+2 working days
Post Settlement	Assigning of shortages for close out	T+2 working days
	Reporting and pick-up of bad delivery	T+4 working days
	Close out of shortages	T+4working days
	Replacement of bad delivery	T+6 working days
	Reporting of re-bad and pick-up	T+8 working days
	Close out of re-bad delivery	T+9 working days

10.5 CLEARING HOUSE AND E-PAYMENT

During May 2005, RBI announced the Payment System in India Vision 2005-2008. The main mission of this scheme was "The establishment of safe, Secure, sound and efficient payment and settlement systems for our country" The four broad tenets of the mission relate to the Safety, Security, Soundness and Efficiency called the 'Triple-S + E'. This statement highlighted the optimum use of technology in payment system like extension of MICR, Real Time Gross Settlement (RTGS) System, and establishment of Clearing Corporation of India Limited (CCIL), Electronic Funds Transfer (EFT) system Participation of a few banks in Electronic Data Interchange (EDI) projects and Initiating steps for Cheque Truncation Pilot Project at New Delhi. Some of the major advances made during recent years in regard to payment. There are various types of electronic clearing systems functioning in the retail payments area in the country. These are given as followings:

Cheque Truncation:

In the mid-term review of the Monetary and Credit Policy Statement of October 2002 it was suggested to constitute a Working Group on Cheque Truncation which will study various models followed all over the world and suggest a procedure for India. The working group was constituted under the chairmanship of Dr. R.B.Barman. Based on the report of this working group RBI is proposing to implement the project on a PILOT basis in the National Capital Region (NCR), New Delhi. Based Truncation is a system to avoid the movement of the physical cheque issued by a drawer to the drawee branch. The physical document will be truncated and sent to the drawee branch as an electronic image along with the relevant information like the MICR fields, date of presentation, presenting banks etc. Cheque Truncation speeds up collection of cheques and therefore enhances customer service, reduces the scope for clearing related frauds, minimizes cost of collection of cheques, reduces reconciliation problems, eliminates logistics problems etc. With the other major product offering in the form of RTGS, the Reserve Bank created the capability to enable inter-bank payments online real time and facilitate corporate customer payments. The other product, National Electronic Funds Transfer, is an electronic credit transfer system.

Cheque Truncation is a more secure system than the current exchange of physical documents in which the cheque moves from one point to another, thus, not only creating delays but inconvenience to the customer in case the instrument is lost in transit or manipulated during the clearing cycle. In addition to operational efficiency, Cheque Truncation has several benefits to the banks and customers which includes introduction of new products, re-engineering the total receipts and payments mechanism of the customers, human resource rationalization, cost effectiveness etc., Cheque Truncation thus is an important efficiency enhancement initiative in the Payments Systems area, undertaken by RBI. The benefits could be summarized as:

· Faster clearing cycle;

· Better reconciliation/verification process

· Better Customer Service Enhanced Customer Window

· T+0 for Local Clearing and T + 1 for inter-city clearing

· Elimination of Float Incentive to shift to Credit Push payments

·The jurisdiction of Clearing House can be extended to the entire country No Geographical Dependence

· Operational Efficiency will benefit the bottom lines of banks Local Clearing activity is a high cost no revenue activity.

· Minimizes Transaction Costs

· Reduces operational risk by securing the transmission route

Electronic Clearing Service (ECS) is a retail payment system that can be used to make bulk payments / receipts of a similar nature especially where each individual payment is of a repetitive nature and of relatively smaller amount. This facility is meant for companies and government departments to make/receive large volumes of payments rather than for funds transfers by individuals. The ECS facility is available in 47 centers across India operated by RBI at places where it manages the clearing houses and by SBI and its associates in other centers. The ECS is further divided into two types – ECS (Credit) to make bulk payments to individuals/vendors and ECS (Debit) to receive bulk utility payments from individuals

National Electronic Funds Transfer (NEFT) system is a nationwide funds transfer system to facilitate transfer of funds from any bank branch to any other bank branch. This is typically for individual / single payments. The system uses the concept of centralized accounting system and the bank's account that is sending or receiving the funds transfer instructions, gets operated at one center, viz. Mumbai only. The individual branches participating in NEFT could be located anywhere across the country. The beneficiary gets the credit on the same Day or the next Day depending on the time of settlement. NEFT operates on a deferred net settlement (DNS) basis which settles transactions in batches. Presently it is settled in six batches the last one being 1600 hrs. on a weekday and 3 batches with the last one being 1200hrs on a Saturday. To participate in NEFT the participating banks branch needs to have IFSC code.

Indian Financial System Code (IFSC) is an alpha numeric code designed to uniquely identify the bank-branches in India. This is 11 digit code with first 4 characters representing the banks code, the next character reserved as control character (Presently 0 appears in the fifth position) and remaining 6 characters to identify the branch. The MICR code has 9 digits to identify the bank-branch.

Large Value Payments

There are a few large value payment systems functioning in the country. These are the Inter-Bank Cheques Clearing Systems (the Inter-bank Clearing), the High Value Cheques Clearing System (the High Value Clearing), the Government Securities Clearing System (the G-Sec Clearing), the

Foreign Exchange Clearing System (the Forex Clearing) and the Real Time Gross Settlement (RTGS) System. All these systems except the High Value Clearings are electronic based systems. These mostly relate to interbank / inter-financial institutional transactions except the High Value Clearing where high value customer cheques are cleared.

The Inter-bank Clearing functions in 7 places and the High Value Clearing in 15 places – both are managed by the Reserve Bank. The G-Sec Clearing and the Forex Clearing are managed by the Clearing Corporation of India Limited (CCIL). The RTGS System is operated by the Reserve Bank. All these are deemed to be Systemically Important Payment Systems (SIPS) and therefore the Reserve Bank has, in line with the international best practices in this regard, moved them (except High Value Clearings) to either secure and guaranteed systems or the RTGS System.

Real Time Gross Settlement (RTGS) is a large value funds transfer system whereby financial intermediaries can settle interbank transfers for their own account as well as for their customers on a "real time" and on "gross" basis. The system effects final settlement of interbank funds transfers on a continuous, transaction- by-transaction basis throughout the processing day(RTGS business hours). The RTGS system is primarily for large value transactions. The minimum amount to be remitted through RTGS is Rs.1 lakh. There is no upper ceiling for RTGS transactions. On a typical day, RTGS handles about 14000 transactions a day for an approximate value of Rs.1,50,000 crore

The remitting customer has to furnish the following information to a bank for effecting a RTGS/NEFT remittance:

1.Amount to be remitted

2. His account number which is to be debited

3. Name of the beneficiary bank

4. Name of the beneficiary customer

5. Account number of the beneficiary customer

6. Sender to receiver information, if any

7. The IFSC code of the receiving branch

While RTGS remittance would be credited to a beneficiary's account by maximum time lag of two hours, NEFT transaction depending on the timing of the transfer will be transferred the same day or the next day and in both the cases when the transfer has not happened the money would be returned to payer's account

Systemically Important Payment Systems (SIPS) – The Committee on Payment and Settlement Systems (CPSS) of Bank for International Settlements (BIS) serves as a forum for central banks to monitor and analyze developments in domestic payment, clearing and settlement systems as well as in cross-border and multicurrency settlement schemes. This committee published core principles of Systemically Important Payment Systems (SIPS). They emphasize the importance of "systemically important" payment systems. If such systems are insufficiently protected against risk, disruption within them could trigger or transmit further disruptions amongst participants or systemic disruptions in the financial area more widely. Systemic importance is determined mainly by the size or nature of the individual payments or their aggregate value. Systems handling specifically large-value payments – mostly interbank transactions – would normally be considered systemically important.

National Electronic Clearing Service (NECS)

The National ECS is a product being developed by the RBI to enable centralized processing of the ECS transactions, in contrast to the existing ECS system that has decentralized operations at 70 locations, spread all over the country. Under the National ECS, the processing of all the ECS transactions would be centralized at the National Clearing Cell at Nariman Point, Mumbai and sponsor banks would need to only upload the relative files to a web server, with online data validation facility. Destination banks would receive their inward clearing data/file at a central location, through the web server. The National ECS would leverage the Core Banking platform of the commercial banks, to enable around 50,000 core-banking-enabled branches of the various banks, to avail of this service. The system would facilitate end-to-end seamless posting of the NECS transactions in a straight-through-processing (STP) environment. This would help the users and member banks to send, receive and process the data files at one centralized place, thereby improving the efficiency of the payment system.

Mobile banking

As you are no doubt aware, with the rapid growth in the number of mobile phone subscribers in India, the banks have been exploring the feasibility of using mobile phones as an alternative channel of delivery of banking services. A few banks have also started offering, through the mobile phone, information-based services like balance enquiry, stop-payment instruction of cheques, record of last five transactions, etc. Considering that the use of this technology for the banking services is relatively new and calls for appropriate safeguards to ensure security of financial transactions, the Reserve Bank has formulated the ‘Draft Operating Guidelines for Mobile Payments in India', through a consultative process and placed them on the RBI’s website in June 2008 for public comments. It is expected that the guidelines when operationalized, would help strengthen the operating environment for mobile banking in the country.

Satellite Banking

The availability of reliable communication network is an important prerequisite for facilitating electronic modes of payment. However, the non-availability of the terrestrial communication link in many parts of the country, particularly the hinterland and hilly areas, poses a major constraint in securing greater penetration of electronic payment services in such areas. For such difficult terrain, which is not connected by terrestrial links, the satellite connectivity is considered to be the appropriate mode of connecting the branches in these areas, as also as a fallback system. In this background, a paper was prepared by a member of the Board for Payment and Settlement Systems of the Reserve Bank on the use of satellite communication technology to facilitate penetration of payment services to the rural areas which are denied these facilities due to non- availability of reliable communication links. A Technical Group constituted by the Reserve Bank has since examined the proposal and recommended the use of satellite connectivity as it would facilitate integration of the rural branches with the core banking solution platform of the banks and help them providing efficient funds-transfer facility to their customers.

However, reckoning the cost implications involved in creating satellite connectivity for the bank branches, the Reserve Bank is considering provision of financial incentive to the banks for adopting this technology. Under the proposal, the RBI would be bearing a part of the leased rentals for the satellite connectivity, provided the banks use it for connecting their branches in the North Eastern States and in the under-banked districts in the rest of the country. A discussion paper on this scheme was placed on RBI website in June 2008 for public comments.

It may add that the satellite communication link is the most disaster-proof, since the satellite, up in the sky, continues to function even in the face of major natural disasters on earth, such as floods or earthquakes. It is, therefore, ideally suited for use as a back-up communication link for the major centres in the country, where a disaster can otherwise disrupt the terrestrial connection.

10.6 REGULATION OF CLEARING HOUSES IN INDIA

Regulation of clearing houses is covered under the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012

Clearing Members

"clearing member" means a member of the Clearing Corporation and includes all categories of clearing members as may be admitted as such by the Clearing Corporation to the Capital Market Segment.

Categories of Clearing Member

The relevant authority may specify from time to time different categories of clearing members and specify different norms and conditions, including for eligibility, admission and cessation of membership. Without prejudice to the generality of the above, the following categories of clearing members are specified as under:

TM Clearing Member

TM clearing member means a clearing member who may clear and settle deals either on his own account or on account of his constituents by effecting delivery and in making and receiving payment for the same in the manner prescribed in these Regulations.

Custodian Clearing Member

Custodian Clearing Member means and includes Custodians, Banks, Trust Companies and other firms admitted by the relevant authority as clearing members who may act for TM clearing members and their constituents in giving and taking delivery of securities, transfer deeds and any other documents by effecting delivery and in making and receiving payment for the same in the manner prescribed in these Regulations herein after called Custodian Clearing Members.

Participant Clearing Member

Participant Clearing Member means and includes banks, financial institutions, primary dealers and other RBI / SEBI regulated entities, admitted by relevant authority, who may clear and settle their own deals in Government securities, put through a Trading Member of the Exchange in the Retail Debt Market of the Capital Market Segment of the Exchange, by effecting delivery and in making and receiving payment for the same in the manner prescribed in these Regulations.

Clearing Member's Responsibility

Without prejudice to the obligations of the Custodian Clearing Member hereunder, the registration and approval of Custodian Clearing Members, shall not in any way affect the jurisdiction of the Clearing Corporation on the concerned TM clearing member in respect of the deals effected by him for or on account of his constituent who settle deals through such Custodian Clearing Members and such clearing member shall continue to remain responsible, accountable and liable to the Clearing Corporation in this behalf.

Regulation of Clearing House

The relevant authority shall prescribe the process from time to time for the functioning and operations of the Clearing House and to regulate the functioning and operations of the Clearing House for the settlement of non depository deals. The Regulations relating to the Clearing House shall be deemed to form a part of any settlement process so provided.

PROVISIONS REGARDING CLEARING HOUSE

Clearance by Members Only

Clearing members only shall be entitled to clear and settle deals through the Clearing House.

Notices and Directions

All clearing members shall comply with the instructions, resolutions, orders, notices, directions and decisions of the relevant authority in all matters connected with the operations of the Clearing House.

False or Misleading Statements

The relevant authority may fine, suspend or expel a clearing member who makes any false or misleading statement in the Clearing Forms required to be submitted in conformity with these Regulations or any resolutions, orders, notices, directions and decisions of the relevant authority thereunder.

Charges for Clearing

The relevant authority shall from time to time prescribe the scale of clearing charges for the clearance and settlement of transactions through the Clearing House.

Clearing House Bills

The Clearing House shall periodically render bills for the charges, fees, fines and other dues payable by clearing members to the Clearing Corporation which would also include the charges for the use of the property as well as the charges, fines and other dues payable on account of the business cleared and settled through the Clearing House and debit the amount payable by such members to their accounts. All such bills shall be paid within a week of the date on which they are rendered.

Liability of the Clearing House

The Clearing House shall not be deemed to guarantee the title, ownership, genuineness, regularity or validity of any security, transfer deed or any other document passing through the Clearing House and the only obligation of the Clearing House in this matter shall be to facilitate the delivery and payment in respect of securities, transfer deed and any other documents between members.

Liability of the Clearing Corporation

No liability shall attach either to the Clearing Corporation or to the relevant authority or any member of the relevant authority by reason of anything done or omitted to be done by the Clearing House in the course of its operations nor shall the Clearing Corporation or the relevant authority or any member of the relevant authority be liable to answer in any way for the title, ownership, genuineness, regularity or validity of any securities, transfer deeds or any other documents passing through the Clearing House nor shall any liability attach to the Clearing Corporation, the relevant authority or any Member of the relevant authority in any way in respect of such securities, transfer deeds and any other documents.

CONDUCT OF BUSINESS BY CLEARING MEMBERS

A) Office Related Procedure

1 Every clearing member shall ensure that all persons acting on his behalf shall subscribe at all times to high standards of professional expertise and integrity.

2 Each clearing member shall at all times maintain such infrastructure, staff, communication facilities and records so as to be able to service his constituents satisfactorily and as per the requirements enumerated in the Clearing Corporation Bye Laws, Rules and Regulations, or any other relevant act(s) in force for that time being.

3 Where the Clearing Corporation feels it necessary, in the public interest to do so, it may at its own instance or on a complaint from another clearing member or client, seek explanation from the clearing member regarding the level of service or professional conduct of the clearing member or any of his staff where such service or conduct has been found unsatisfactory or contrary to principles enumerated in the Clearing Corporation Bye Laws, Rules and Regulations, or notifications, directions or circulars issued thereunder.

B) Supervision

1 Procedures to be followed

(a) Each clearing member shall establish, maintain, and enforce procedures to supervise its business and to supervise the activities of its employees that are reasonably designed to achieve compliance with the Clearing Corporation Bye Laws, Rules and Regulations and any notifications, directions etc. issued thereunder as well as the relevant statutory acts.

(b) The CM clearing member shall maintain an internal record of the names of all persons who are designated as supervisory personnel and the dates for which such designation is or was effective. Such record shall be preserved by the CM clearing member for a period of not less than three years.

(c) Every CM clearing member shall specifically authorize in writing person or persons, who may be authorized to transact on behalf of the clearing member and to do such acts which clearing member may wish to delegate to such person, and make available a copy of such power of attorney to the Clearing Corporation before such person transacts any business on the Clearing Corporation.

(d) A clearing member shall maintain such records and make available to inspection by any person authorized in this behalf by the Clearing Corporation, the information related to such Clearing member's financial condition as prescribed by the Clearing Corporation for this purpose.

(e) The clearing member shall pay such fees, charges and other sum as the Clearing Corporation may notify from time to time, in such time and manner as required by the Clearing Corporation.

(f) The clearing member must inform the Clearing Corporation of any change in the status and constitution, operation, activities of the clearing member's entity.

2 Internal inspections

Each clearing member shall conduct a review, at least annually, of the business in which it engages, which shall be reasonably designed to assist in detecting and preventing violations of and achieving compliance with Bye Laws, Rules and Regulations.

3 Written Approval

Each clearing member shall establish procedures for the review and endorsement by an appropriate senior officer in writing, on an internal record, of all transactions and all correspondence of its employees pertaining to the solicitation of any securities transaction.

C) Relation with the Constituents

1) When establishing a relationship with a new client, clearing members must take reasonable steps to assess the background, genuineness, financial soundness of such person, and his objectives.

2) Clearing member shall make the constituent aware of the precise nature of the clearing member's liability for business to be conducted, including any limitations on that liability and the capacity in which the clearing member acts and the constituents liability thereon.

3) Clearing member shall provide extracts of relevant provisions governing the rights and obligations of constituents as constituents of clearing members as prescribed in the Bye Laws, Rules and Regulations, relevant manuals, notifications, circulars any additions or amendments

thereto, etc. of the Clearing Corporation, or of any regulatory authority, to the extent it governs the relationship between clearing members and constituents, to the constituents at no extra cost. The clearing member shall also bring to the notice of his constituents, any indictments,

penalties, etc. imposed on him by the Clearing Corporation or any other regulatory authority.

4) Recommendations to the Constituents

1) A clearing member shall make adequate disclosures of relevant material information in its dealing with his constituents.

2) No clearing member or person associated with the clearing member shall guarantee a constituent against a loss in any securities transactions effected by the clearing member with or for such constituent.

CODE OF CONDUCT FOR CLEARING MEMBERS

1 General Principles

1.1 Professionalism

A clearing member in the conduct of his business, shall observe high standards of commercial honour of just and equitable principles of trade. A clearing member shall have and employ effectively the resources and procedures which are needed for the proper performance of his

business activities.

1.2 Loyalties to Clearing Practices

Clearing members shall adhere to the Rules, Regulations and Bye Laws of the Clearing Corporation and shall comply with such operational parameters, rulings, notices, guidelines and instructions of the relevant authority as may be applicable from time to time.

1.3. Honesty and Fairness

In conducting his business activities, a clearing member shall act honestly and fairly, in the best interests of his constituents.

2 Settlement Principles

2.1 Clearing members shall ensure that the fiduciary and other obligations imposed on them and their staff by the various statutory acts, Rules and Regulations are complied with.

2.2 Clearing members shall ensure that employees are adequately trained in the practices of the relevant clearing segment in which they deal, clear and settle, are aware of their own, and their organization's responsibilities as well as the relevant statutory acts governing the clearing member, the Rules, Bye Laws and Regulations of the Clearing Corporation including any additions or amendments thereof.

2.3 When entering into transactions on behalf of constituents, the clearing members shall ensure that they abide by the Code of Conduct and regulations as enumerated in the current chapter of these regulations.

2.4 No clearing member or person associated with a clearing member shall make improper use of constituents securities or funds.

2.5 When entering into or arranging transactions, clearing members must ensure that at all times great care is taken not to misrepresent in any way the nature of transaction.

2.6 No clearing member shall exercise any discretionary power in a client's account unless such client has given prior written authorization to a stated individual or individuals and the account has been accepted by the clearing member, as evidenced in writing by the clearing member.

GENERAL OBLIGATIONS OF CLEARING HOUSES

Clearing and settlement of trades.

Every recognized stock exchange shall, with effect from the date specified by the Board

in this behalf, use the services of recognized clearing corporation(s) for clearing and

settlement of its trades.

Agreement between stock exchange and clearing corporation.

(1) Subject to provisions of sub-regulation (2), a recognized stock exchange shall avail the service of a recognized clearing corporation pursuant to an agreement in writing between them stipulating their rights and obligations, the conditions for admission of securities for clearing and settlement, risk management measures, charges for clearing and settlement and other incidental and consequential matters.

(2) The recognized stock exchange shall extend its arbitration mechanism for settlement of disputes or claims arising out of clearing and settlement of trades executed on such stock exchange.

Admission of securities for clearing and settlement.

A recognized clearing corporation shall seek approval of the Board before extending its services to any segment of a recognized stock exchange and before admitting any securities for clearing and settlement.

Fund to guarantee settlement of trades.

(1) Every recognized clearing corporation shall establish and maintain a Fund by whatever name called, for each segment, to guarantee the settlement of trades executed in respective segment of a recognized stock exchange.

(2) The Settlement Guarantee Fund or the Trade Guarantee Fund of an existing recognized stock exchange shall be transferred to the recognized clearing corporation to which the clearing and settlement functions of the stock exchange are transferred.

(3) Till such time the Fund is transferred under sub-regulation (2), it shall be utilized only for the purposes of meeting settlement obligations as specified by the Board and as per the byelaws of the recognized stock exchange.

(4) An existing clearing corporation shall continue to utilize its Settlement Guarantee Fund or Trade Guarantee Fund after its recognition under these regulations.

(5) In the event of a clearing member failing to honour his settlement obligations, the Fund shall be utilized to complete the settlement.

(6) The corpus of the Fund shall be adequate to meet the settlement obligations arising on account of failure of clearing member(s).

(7) The sufficiency of the corpus of the Fund shall be tested by way of periodic stress tests, in the manner specified by the Board.

(8) The contribution and utilization of the Fund shall be in accordance with the norms specified by the Board.

10.7 SUMMARY

The Clearing House is entitled to distribute securities which it has received from a clearing member under these regulations to another clearing member who is entitled under these regulations to receive delivery of securities. A clearing member may nominate two or more clearing assistants as may be specified by the relevant authority from time to time, who shall be competent to sign on behalf of such clearing member all clearing forms. A clearing member who has to give or take delivery of securities, transfer deed or any other documents or to make or accept payments shall either attend personally in the Clearing House or be represented by his clearing assistant at the proper time. The clearing banks and depositories provide the necessary interface between the custodians/clearing members for settlement of funds/securities obligations of trading members. For clearing purpose there are the Inter-Bank Cheques Clearing Systems, the High Value Cheques Clearing System, the Government Securities Clearing System, the Foreign Exchange Clearing System and the Real Time Gross Settlement System. The Clearing House shall periodically make bills for the charges, fees, fines and other dues payable by clearing members to the Clearing Corporation and settled through the Clearing House and debit the amount payable by such members. The obligation of the Clearing House in this matter shall be to facilitate the delivery and payment in respect of securities, transfer deed and any other documents between members.

10.8 KEYWORDS

Collecting Banker : The bank which helps in collecting the cheque is called as collecting banker.

Clearing House : An agency or separate corporation of a futures exchange responsible for settling trading accounts, clearing trades, collecting and maintaining margin monies, regulating delivery and reporting trading data.

10.9 REVIEW QUESTIONS

1. What do understand by Bank's Clearing House? Explain the banker's clearing system in India?
2. Explain the main functions of Clearing House in India?
3. Explicate the clearing process of various Money Market Instrument?
4. Describe the clearing house e-payment in India?
5. Discuss the regulation of clearing houses in India?

10.10 SUGGESTED READINGS

- Gordon, E. & Natarajan, K., Capital Market in India, Himalaya Publishing House, Ramdoot, Dr. Bhalerao Marg, Girgaon, Mumbai - 400004.
- Aggarwal, S., Guide to Indian Capital Market; Bharat Law House, 22, Tarun Enclave, Pitampura, New Delhi – 110 034.
- Khan, M.Y., Indian Financial Systems; Tata McGraw Hill, 4/12, Asaf Ali Road, New Delhi – 110 002.
- Shashi K Gupta, Nishja Aggarwal and Neeti Gupta, Financial Institutions and Markets ; Kalyani Publishers, 4863/2B, Bharat Ram Road, 24, Daryaganj, New Delhi -110002

LESSION-11 BANKING REGULATION ACT, 1949

STRUCTURE

11.0 OBJECTIVES

11.1 INTRODUCTION

11.2 DEFINITION AND MEANING

11.3 OBJECTIVES OF BANKING REGULATION

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11.5 RECENT DEVELOPMENT IN BANKING REGULATION ACT.1949

11.6 SUMMARY

11.7 KEYWORDS

11.8 REVIEW QUESTIONS

11.9 FURTHER READINGS

11.0 OBJECTIVE

After going through this lesson, the learners will be able to know the:

- Describe the meaning of banking regulation and requirement for the banking sector.
- Understand the objective of banking regulation in India.
- Describe the main features of the banking regulation act.1949
- Information about powers and duties of RBI and schedule commercial banks.
- Knowledge of recent development in banking regulation act.1949

11.1 INTRODUCTION

Banking is commonly treated as a matter of public interest. Banking industry is tightly regulated by various laws and regulations (prescribed and enforced by various governments) that controls and influences many aspects of banking. This article explains how the bank regulations have evolved across globe to serve numerous goals. The Banking Companies Act, presently known as Banking Regulation Act was enacted owing to safeguard the interest of the depositors, control abuse of powers by some bank personnel controlling the banks in particular and to the interest of Indian economy in general. However, it should be remembered that this Act is in addition to, and not, except as otherwise provided, in derogation of the Companies Act, 1956 and any other law for the time being in force. Since, some historic events took place in Indian Banking System, detailed discussion on the various provisions of the Act would leave some scope of incompleteness without mentioning those developments. The Social Control Act of 1968 under the leadership of the then Deputy Prime

Minister, Mr. Morarji Desai was an amending act of the Banking Regulation Act. The followings were the main provisions of this amending Act:-

• Bigger banks have to be managed by whole time chairman possessing special knowledge and practical experience of the working of a banking company or of finance, economics or business administration

• The majority of the directors had to be persons with special knowledge or practical experience in any of the areas such as accountancy, agriculture, rural economy, banking, co-operative, economics, finance, law, small scale industries

• At least two directors had to possess special knowledge and practical experience in respect of agriculture, rural economy and co-operation.

• The banks were also prohibited from making any loans or advances, secured or unsecured to their directors or to any companies in which they have substantial interest.

But, considering the social control measure as inadequate one, the Government of India took another historic decision of Nationalization of 14 Indian banks through an ordinance under the leadership of the then Prime Minister Mrs. Indira Gandhi and, accordingly, with effect from 19th, July, 1969 those 14 banks were taken over by the Govt. of India under the Banking Companies (Acquisition & Transfer of Undertakings) Act of 1969. Again in 1980 another six banks were taken over on 14th March, 1980 under the Banking Companies (Acquisition and Transfer of Undertakings Act) 1980. No foreign banks were nationalized.

On the other hand, well before nationalization, State Bank of India Act, 1955 was enacted to convert Imperial bank of India to SBI and in 1959 " State Bank of India(Subsidiary) Act was passed and eight Indian banks were made subsidiaries to State Bank of India. As a result in the Indian Banking System, the number of public sector banks figured to 29 (20 nationalized & 9 banks comprising SBI & 8 subsidiaries). However, at present no of public sector banks are 27 after merging of nationalized bank "New Bank of India" with "Punjab National Bank" in 1993 and amalgamation of two subsidiaries of SBI viz. State Bank of Bikaner and State Bank of Jaipur into one as "State Bank of Bikaner & Jaipur". Besides these, in Indian banking system there are indigenous old private banks, new generation private banks and foreign banks.

11.2 DEFINITION AND MEANING

Bank regulations are a form of government regulation which subject banks to certain requirements, restrictions, policies, procedures, standards, disclosures and guidelines. This regulatory structure creates transparency between banking institutions and the individuals & corporations with whom they conduct business.

The fundamental rationale for exercising fairly close regulation and supervision of banking institutions, all over the world, is premised on the notion that the banks are "too big to fail". This originates from the fact that many financial institutions (particularly investment banks with a commercial arm) hold too much influence and control over the economy to fail without enormous consequences. The belief is that if not regulated, there exists a risk of banking institutions being crippled creating rippling effects throughout the economy.

This enormous influence that banks hold over the economy is because banks are special institutions. They accept public deposits without offering any collateral security, run the payment and settlement system, and are an important channel for monetary policy transmission. Through a combination of lending and deposit activities, the banking system can affect the aggregate supply of money and credit, making banks a crucial link in the monetary mechanism and in the overall condition of the economy. Banks are keystone in the edifice of financial stability of the system. Ensuring safety and soundness of the banking system, therefore, becomes a predominant objective of the financial regulators.

11.3 OBJECTIVES OF BANKING REGULATION

Objectives of Bank Regulation:

The objectives of bank regulation, and the emphasis, vary between jurisdictions. The most common objectives are:

Prudential (Protection of Depositors):

The most basic reason for regulation of banking is depositor protection. Pressure for such regulation arose as the public began making financial transactions through banks, and as businesses and individuals began holding a significant portion of their funds in banks. Today most countries adopt fractional reserve system of banking where deposits are only partially backed by the reserves banks hold in the form of cash and balances maintained with the Central Banks of the country. As a result, depositor safety is linked to many other factors as well, including the capital in a bank and the condition and value of its loans, securities, and other assets. Thus one of the key objectives of banking regulations is to reduce the level of risk to which bank creditors are exposed (i.e. to protect depositors).

Systemic Risk Reduction - Monetary and Financial Stability:

In the modern world, vast volume of transactions is conducted every day by individuals and businesses. This multitude of daily transactions needs to be completed with a high degree of certainty and safety and hence a safe and acceptable means of payment is critical to the health of our economy. Absence of an effective payment system would result in serious disruptions in functioning of today's complex national economies, as hindrance in financial transactions would impact the flow of credit, leading to slippages in the depositor confidence.

Banking regulations are enforced to ensure that fluctuations in business activity and problems at individual banks does not impact the flow of transactions across the country's economy and shake the public confidence in the banking system. Specific laws and regulations have been enacted by various countries to prescribe which institutions can offer deposit accounts, the level of reserves that must be held against these accounts, and the various deposit reports that must be filed. These regulations reduce the risk of disruption resulting from adverse trading conditions for banks causing multiple or major bank failures

Efficient and Competitive Financial System:

Like any other industry, banking industry must allow for customers getting quality services at competitive prices. Another purpose of bank regulation is to create a regulatory framework that encourages efficiency as well as competition and ensures an adequate level of banking services throughout the economy. To achieve efficiency banks must utilize their resources wisely, be innovative and design new effective products/services for consumers, and manage their risks effectively. This can be achieved by creating a healthy competitive environment for banking industry. Without such competition, individual banks might attempt to gain higher prices for their services by restricting output or colluding with other banks.

Competition and efficiency depend on the number of banks operating in a market, the freedom of other banks to enter and compete, and the ability of banks to achieve an appropriate size for serving their customers. Regulation should foster a banking system that can create an effective competitive environment, prescribe entry and exit barriers and evolve in response to changing economic conditions and technological advances.

Consumer Protection

Banking Regulation also strives to protect consumer interests in various aspects of a banking relationship. Several examples are; requiring banks to provide their customers with a meaningful disclosure of deposit and credit terms, enforcing equal treatment and equal access to credit among all financial customers, promoting financial privacy and preventing problems and abusive practices during credit transactions or debt collections.

The growing complexity of financial instruments and the uniqueness of individual customers have made consumer protection a very complicated and detailed regulatory process.

Avoiding Money Laundering:

Another aim of banking regulations is to avoid the misuse of banks. Money Laundering involves transactions intended to disguise the true source of funds; disguise the ultimate disposition of the funds; eliminate any audit trail and make it appear as though the funds came through legitimate sources; and evade taxes. Money laundering keep away the integrity of a nation’s financial system by reducing tax revenues through underground economies, restricting fair competition with legitimate businesses, and disrupting economic development.

Governments and International Bodies undertake efforts to deter prevent and apprehend money launderers. Banking regulations are enacted to reduce the risk of banks being used for criminal purposes for example using banking channels for laundering the proceeds of crime.

Credit Allocation:

Banking Industry especially the Central Banks of any country play an active, important and direct role in supporting developmental activities in their respective country. This developmental role includes ensuring credit to productive sectors of the economy, creating institutions to build financial infrastructure, and expanding access to affordable financial services. Regulations enforce credit allocation to priority sector and encourage lending to these sectors by way of various initiatives and benefits. These regulations also help access to credit to the neglected sectors in any economy, driving principle being to ensure adequate flow of bank credit to those sectors of the society/economy that impact large segments of the population and weaker sections, and to the sectors which are employment-intensive, such as, agriculture and small enterprises.

11.4 FEATURES OF THE BANKING REGULATION ACT-1949

The Act as it stands now provides for the following controls:-

1. Minimum Paid-up Capital

2. Classification of Companies into Banking and Non-Banking Companies

3. Licensing of Banking Companies

4. Restriction on Branch Banking

5. Maintenance of Cash Reserves

6. Maintenance of Assets in India

7. Minimum Liquid Asset Ratio

8. Prohibition of Common Directors

9. Restriction on Payment of Dividend and Transfer of a certain percentage of profit to the Reserve Fund

10. Restriction on Nature of Subsidiary Company

11. Accounts and Balance Sheet

12. Inspection of Banking Companies

13. Suspension of Business and Winding up

14. Schemes for Arrangement and Amalgamation

15. Compulsory Amalgamation of Banking Company

Some important features of regulations of Banking Regulations ACT-1949

Banking – According to Section 5(b), banking means accepting for lending or investment of deposits of money from public repayable on demand or otherwise and with drawable by cheque, drafts order or otherwise.

Banking business – According to Section 6(1) , accepting deposits, borrowing money, lending money, dealing in bills, buying/selling forex, lockers, issuing LC travellers' cheques, mortgages, insurance business, acting as trustee etc or other business notified by central Govt. in the official Gazette.

Immovable property (IP) – According to Section 9, Banks cannot hold IP except for own use max. for 7 years from acquisition. RBI may extend by 5 years.

Paid up capital, reserves – According to Section 11&12, Foreign banks : min Rs 15 lac (Rs. 20 lac for business in Mumbai and/or Calcutta) For domestic banks: not less than Rs 5 lac. Ratio of authorized, subscribed and paid up capital minimum 4:2:1. voting right cannot be more than 10% by a single shareholder irrespective of holding of the shareholder.

According to Section 17(1) To create reserve fund and 20% of profits to be transferred to the fund before dividend is declared (RBI directed) banks to transfer not less than 25% of net profits to Reserve Fund w.e.f. March 31, 2001)

According to Section 19 Permits banks to form subsidiary company for certain purposes

According to Section 19(2) Banking company can hold shares in any company, as pledge, mortgagee or absolute owners. Max amount 30% of the paid up share capital of that company whichever is less.

According to Section 20(a) Banks cannot grant loan against security of their own shares.

According to Section 21 Control over advanced- RBI issues directive to banks of loan policy and rate of other conditions.

According to Section 22. Licence for Bank – obtaining of licence from RBI is essential

According to Section 23. Branch licencing- RBI authority on branch licensing.

Statutory Liquidity Ration - According to Section 24, Banks to maintain by way of cash, gold, preceding fortnight (details available separately)

Unclaimed deposits – According to Section 26, Return of unclaimed deposits (10 years and above) within 30 days of close of each calendar year to RBI

Inspection of banks – According to Section 35, RBI authorized to inspect banks and give directions, as deemed appropriate. RBI has directed banks to round off transactions to nearest rupee u/s 21 and section 35.

35A-Power to give directions in public interest / banking policy.

45Y-Preservation of Records – Central Govt has powers to frame rules specifying period for which a bank shall preserve its books

45ZA-ZF-Nomination on bank deposits, safe deposit and lockers.

45Z-Return of paid instruments, to a customer by keeping a true copy, Customers obtaining original instruments to preserve instruments as prescribed by central Govt u/s 45Y.

49A-Other than a banking company/RBISBL, no person can accept deposits of money withdrawable by cheque.

11.5 RECENT DEVELOPMENT IN BANKING REGULATION ACT.1949

The Banking Regulation Act, 1949 has been in force for more than six decades. It empowers the Reserve Bank of India (RBI) to regulate and supervise the Indian banking sector. The amendment to the bill seeks to strengthen the RBI's regulatory powers and strengthen the Indian banking sector. The bill was first introduced in the Lok Sabha on May 13, 2005. It was then referred to the Standing Committee on Finance for examination and, after the submission of its report, the official amendments to the Bill were moved in the Lok Sabha. However, the bill could not be taken up for consideration in the 14th Lok Sabha and it lapsed after the dissolution of the Lower House in 2009.

The Bill presented to the Lok Sabha in 2011 incorporates certain provisions of the Banking Regulation (Amendment) Bill, 2005. Other consequential amendments include Banking Companies (Acquisition and Transfer of Undertakings) Act 1970 and 1980 that seeks to grant greater flexibility to private banks in raising capital to meet the requirements of their expanding business.

The salient features of the Banking Laws (Amendment) Act are as follows:

1. **MORE POWER TO THE RBI**

a) New bank licenses and greater supervisory oversight

The Act will enable the RBI to issue new bank licenses to corporate houses and strengthen the RBI's hand with powers to supersede entire boards of recalcitrant banks that fail to comply with its directions. Before the amendment, the RBI only had powers to remove a director or officers of a banking company and not the full board. But with this amendment, the RBI will now have the power to supersede the entire board, in public interest, and appoint an administrator to run the bank for a period not exceeding 12 months. The amendment will also increase the rates of existing monetary penalties that RBI can impose on a bank if it disobeys its rules and directives or gives false information.

b) Power to Inspect

The amendment also gives powers to the RBI to call for information and returns from the associate and group companies of the banking companies and to inspect them, if necessary. These powers will give greater supervisory oversight when the RBI proposes to grant licenses to industrial houses for setting up new banks, which is currently under consideration. The bill also substantially increases the penalties and fines for some of the violations of the Banking Regulation Act and the rules framed under it. The Act also empowers the RBI to demand penalty interest from the bank if the bank fails to maintain the prescribed minimum amount of Cash Reserve Ratio (CRR) on any given day.

c) Acquisition of Shares and Voting Rights

An acquisition of 5 percent or more shares or voting rights will now require the RBI's prior approval. The RBI shall be empowered to impose such conditions as it deems fit in this regard.

d) Unclaimed Bank Accounts

RBI will have the power to transfer the money lying in the bank account, which is not operated by the account holder for more than 10 years, to the "Depositor Education and Awareness Fund". The fund will be managed by a committee appointed by the RBI and will be utilized to create awareness among the customers. In case the account holder returns, the money shall be returned to the account holder by the bank, with interest.

2. AMENDMENTS RELATED TO PRIVATE AND PUBLIC SECTOR BANKS

a) Revised voting rights

Private Sector Banks: The cap on voting rights in private banks has been raised to 26 percent from the earlier 10 percent. This means that the promoters and their group will now have voting powers up to 26 percent.

Public Sector Banks: This amended law also enables the government to raise voting rights in state banks, such as the State Bank of India, to 10 percent from the existing 1 percent. This amendment will make the voting rights proportional to the number of shares held by shareholders and will attract foreign institutional investors, who have been sitting on the sidelines as far as investing in these banks is concerned.

b) Issue of bonus shares by public sector banks

The amendment enables nationalized banks to raise capital through "bonus" and "rights" issue and also enables public sector banks to increase or decrease the authorized capital with approval from the

Government of India and RBI without being limited by the ceiling of a maximum of Rs. 30 billion (approximately US $600 million,) under the Banking Companies (Acquisitions and Transfer of Undertakings) Act of 1970 and 1980.

c) Mergers & Acquisitions

The Competition Commission of India (CCI) will approve all Mergers and Acquisitions (M&A) in banks except for the case of banks in trouble. In such cases, the RBI will have the final authority.

d) Stamp duty for foreign banks

The Act will allow foreign banks to convert their Indian operations into local subsidiaries or transfer shareholding to a holding company of the bank without paying stamp duty. This move will be helpful for the foreign banks to expand their business operations into India.

11.6 SUMMARY

Banking industry is regulated by various laws and regulations that controls and influences many aspects of banking. Bank regulations are a form of government regulation which subjects banks to certain requirements, restrictions, policies, procedures, standards, disclosures and guidelines. The fundamental rationale for exercising regulation and supervision of banking institutions is premised on the notion that the banks are "too big to fail".

In India the Reserve Bank of India (RBI) is empowered to regulate and supervise the Indian banking sector. Other consequential amendments include Banking Companies (Acquisition and Transfer of Undertakings) Act 1970 and 1980 that seeks to grant greater flexibility to private banks in raising capital to meet the requirements of their expanding business. The Act will enable the RBI to issue new bank licenses to corporate houses and strengthen the RBI's hand with powers to supersede entire boards of recalcitrant banks that fail to comply with its directions. The Act also empowers the RBI to demand penalty interest from the bank if the bank fails to maintain the prescribed minimum amount of Cash Reserve Ratio (CRR) on any given day. Private Sector Banks: The cap on voting rights in private banks has been raised to 26 percent from the earlier 10 percent. Public Sector Banks: This amended law also enables the government to raise voting rights in state banks, such as the State Bank of India, to 10 percent from the existing 1 percent. The amendment enables nationalized banks to raise capital through "bonus" and "rights" issue and also enables public sector banks to increase or decrease the authorized capital with approval from the different sectors.

11.7 KEYWORDS

Banking : According to Section 5(b), banking means accepting for lending or investment of deposits of money from public repayable on demand or otherwise and with drawable by cheque, drafts order or otherwise.

Banking business : According to Section 6(1) , accepting deposits, borrowing money, lending money, dealing in bills, buying/selling forex, lockers, issuing traveller cheques, mortgages, insurance business, acting as trustee etc or other business notified by central Govt. in the official Gazette.

Bank Regulations : are a form of government regulation which subject banks to certain requirements, restrictions, policies, procedures, standards, disclosures and guidelines.

11.8 REVIEW QUESTIONS

1. What do you mean by banking regulation also state the objectives of banking regulation?
2. Explain in detail the features of the banking regulation act.1949
3. Give details about the recent development in banking regulation act.1949

11.9 SUGGESTED READINGS

- Tannan, M.L., Tannan's Banking Law and Practice in India in India (Eighth Edition-2008), India Law House, New Delhi,2 volumes.
- Gupta, R. K., Banking Laws and Practice, Modern law Press, New Delhi.
- Bas,. A., Review of Current Banking Theory and Practise (1998) Macmillan.
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LESSON-12 RBI ACT-1934

STRUCTURE

12.0 OBJECTIVE

After going through this lesson, the learners will be able to know the:

- Definition and meaning of banking regulation act-1934.
- Application of banking regulation act-1934 in India.
- Features of the banking regulation act-1934.
- Powers duties of RBI and schedule commercial banks.
- Recent development in banking regulation act-1934.

12.1 INTRODUCTION

In Indian, the banking regulation act-1934 describes the establishment, organization and power of a central bank. That's why it became necessary that before knowing about the banking regulation act-1934, we must be knowledge of central banking. The Central Bank is a top financial institution of a country. It is needed to regulate and control the monetary system of an economy. The need for a central bank in India was felt during 18th century. The earliest attempts to set up a central bank dates back to 1773 when Warren Hastings recommended to establish the "General Bank of Bengal and Bihar" as Central Bank of India. In 1913 Lord Keynes also recommended to set up a Central Bank. Later on in 1921, by amalgamating three presidency Banks (Presidency Bank of Bengal, Presidency Bank of Madras and Presidency Bank of Bombay), Imperial Bank of India was set up. Though Imperial Bank of India performed certain central banking function, but the right of Note issue was not given to Imperial Bank of India and Government of India performed the function of credit control. The establishment of a Central Bank that would issue notes and at the same time function as banker to the Government was recommended in 1926 by the Royal Commission in India Currency and Finance (known as the Hilton Young Commission). In 1931, Central Banking inquiry committee also recommended for setting up of a Central Bank in India.

In 1933, the "Round Table Conference" also suggested to set up a Central Bank free from political influence. As a result of all these recommendations and suggestions, a fresh bill was passed by the assembly on December 22, 1933 and got Governor General Ascent on March 6, 1934. Thus the Reserve Bank of India started working since, 1st April, 1935 in accordance with the provision of the Reserve Bank of India Act, 1934. The pattern of central banking in India was based on the Bank of England. England has a highly developed banking system in which the functioning of the central bank as a banker's bank and their regulation of money supply set the pattern. The central bank's function as 'lender of last resort' was on the condition that the banks maintain stable cash ratios as prescribed from time to time. The effective functioning of the British model depends on an active securities market where open market operations can be conducted at the discount rate. The effectiveness of open market operations however depends on the member bank's dependence on the central bank and the influence it wields on interest rates. Later models, especially those in developing countries showed that central banks play an advisory role and render technical services in the field of foreign exchange, foster the growth of a sound financial system and act as a banker to government.

12.2 DEFINITION AND MEANING

A modern central bank carry out so many functions of different nature that it is very difficult to give any brief but accurate definition of a central bank. Any definition of a central bank is derived from its functions and these functions have varied from time to time and from country to country. We may say that a central bank is one which acts as the banker to the governments and the commercial banks, has the monopoly of note issue, operates the currency and credit system of the country and does not perform the ordinary commercial banking function.

Economists have defined central bank differently, emphasizing its one function or the other. In the statutes of the Bank for International Settlements, a central bank is the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in the country.

A central bank is a bank which constitutes the head of the monetary and banking structure of its country and which performs, as best as it can in the national economic interest, the following functions :

(a) The regulation of currency in accordance with the requirements of business and the general public, for which purpose it is granted either the sole right of note issue or at least a partial monopoly thereof.
(b) The performance of general banking and agency services for the Government.
(c) The custody of the cash reserves of the commercial banks.

(d) The custody and the management of the nation's reserves of international currencies.

(e) The provision of credit facilities in the form of rediscounts or collateral advances, to commercial banks, discount houses, bill brokers and dealers or other banking institutions, in its capacity as the bankers' bank and the general acceptance of the responsibility of lender of last resort.

(f) The settlement of clearance balances between the banks and the provision of facilities for the transfer of funds between all important centres.

(g) The control of credit in accordance with the needs of business and the economy generally and for the purpose of carrying out the broad monetary policy adopted by the Government.

While the older central banks performed the functions enumerated above mostly as the result of tradition, the newer central banks and some of those functions specifically entrusted to them by statute. The preamble to the Reserve Bank of India Act referred to that bank as being constituted to "regulate the issue of bank notes and the keeping of 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".

Moreover, the statutes of many of the newer central banks circumscribe their powers and functions to such an extent that those statutes amount almost to a definition of what a central bank should or should not do. The noticeable trend in central banking legislation towards a more or less standard type, after allowing for the political constitution and the stage of economic development of different countries, affords a practical illustration of the existence of a clearly defined concept of central banking.

The Reserve Bank of India is the central bank of the country. Central banks are a relatively recent innovation and most central banks, were established around the early twentieth century.

The Reserve Bank of India was set up on the basis of the recommendations of the Hilton Young Commission. The Reserve Bank of India Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank, which commenced operations on April 1, 1935.

The Bank was constituted to

- Regulate the issue of banknotes
- Maintain reserves with a view to securing monetary stability and
- To operate the credit and currency system of the country to its advantage.

The Bank began its operations by taking over from the Government the functions so far being performed by the Controller of Currency and from the Imperial Bank of India, the management of Government accounts and public debt. The existing currency offices at Calcutta, Bombay, Madras, Rangoon, Karachi, Lahore and Cawnpore (Kanpur) became branches of the Issue Department. Offices of the Banking Department were established in Calcutta, Bombay, Madras, Delhi and Rangoon.

Burma (Myanmar) seceded from the Indian Union in 1937 but the Reserve Bank continued to act as the Central Bank for Burma till Japanese Occupation of Burma and later upto April, 1947. After the partition of India, the Reserve Bank served as the central bank of Pakistan upto June 1948 when the State Bank of Pakistan commenced operations. The Bank, which was originally set up as a shareholder's bank, was nationalised in 1949.

An interesting feature of the Reserve Bank of India was that at its very beginning, the Bank was seen as playing a special role in the context of development, especially Agriculture. When India commenced its plan endeavours, the development role of the Bank came into focus, especially in the sixties when the Reserve Bank, in many ways, pioneered the concept and practise of using finance to promote development. The Bank was also instrumental in institutional development and helped set up institutions like the Deposit Insurance and Credit Guarantee Corporation of India, the Unit Trust of India, the Industrial Development Bank of India, the National Bank of Agriculture and Rural Development, the Discount and Finance House of India etc. to build the financial infrastructure of the country.

With liberalization, the Bank's focus has shifted back to core central banking functions like Monetary Policy, Bank Supervision and Regulation, and Overseeing the Payments System and onto developing the financial markets.

12.3 FEATURES OF THE BANKING REGULATION ACT.1934

12.3.a Preliminary features

1. Short title, extent and commencement.

(1) This Act may be called the Reserve Bank of India Act, 1934.

(2) It extends to the whole of India.

(3) This section shall come into force at once, and the remaining provisions of this Act shall come into force on such date or dates as the Central Government may, by notification in the Gazette of India, appoint.

2. Definitions.

In this Act, unless there is anything repugnant in the subject or context, –

"the Bank" means the Reserve Bank of India constituted by this Act;

“Bank for International Settlements” means the body corporate established with the said name under the law of Switzerland in pursuance of an agreement dated the 20th January, 1930, signed at the Hague;

“the Central Board” means the Central Board of Directors of the Bank;

“Deposit Insurance Corporation” means the Deposit Insurance Corporation established under section 3 of the Deposit Insurance Corporation Act, 1961;

“Exim Bank” means the Export-Import Bank of India established under the Export-Import Bank of India Act, 1981;

“foreign currency” and “foreign exchange” have the meanings respectively assigned to them in the Foreign Exchange Regulation Act, 1973;

“Industrial Finance Corporation” means the Industrial Finance Corporation of India established under the Industrial Finance Corporation Act, 1948;

“International Development Association” means the “Association” referred to in the International Development Association (Status, Immunities and Privileges) Act, 1960;

“International Finance Corporation” means the “Corporation” referred to in the International Finance Corporation (Status, Immunities and Privileges) Act, 1958;

“International Monetary Fund” and “International Bank for Reconstruction and Development” mean respectively the “International Fund” and the “International Bank”, referred to in the International Monetary Fund and Bank Act, 1945;

“National Bank” means the National Bank for Agriculture and Rural Development established under section 3 of the National Bank for Agriculture and Rural Development Act, 1981;

“National Housing Bank” means the National Housing Bank established under section 3 of the National Housing Bank Act, 1987;

“Reconstruction Bank” means the Industrial Reconstruction Bank of India established under section 3 of the Industrial Reconstruction Bank of India, Act, 1984;

“rupee coin” means rupees which are legal tender under the provisions of the Indian Coinage Act, 1906;

“scheduled bank” means a bank included in the Second Schedule;

“Sponsor Bank” means a Sponsor Bank as defined in the Regional Rural Banks Act, 1976;

“State Bank” means the State Bank of India constituted under the State Bank of India Act, 1955;

“Small Industries Bank” means the Small Industries Development Bank of India established under Section 3 of the Small Industries Development Bank of India Act, 1989”.

“State Financial Corporation” means any State Financial Corporation established under the State Financial Corporations Act 1951;

“Unit Trust” means the Unit Trust of India established under section 3 of the Unit Trust of India Act, 1963;

“agricultural operations”, “central co-operative bank”, “co-operative society”, “crops”, “marketing of crops”, “pisciculture”, “regional rural bank” and “State co-operative bank” shall have the meanings respectively assigned to them in the National Bank for Agriculture and Rural Development Act, 1981;

"co-operative bank", "co-operative credit society", "director", "primary agricultural credit society", "primary co-operative bank" and "primary credit society" shall have the meanings respectively assigned to them in Part V of the Banking Regulation Act, 1949;

12.3.b Incorporation, capital, management and business features

3. Establishment and incorporation of Reserve Bank.

(1) A bank to be called the Reserve Bank of India shall be constituted for the purposes of taking over the management of the currency from the Central Government and of carrying on the business of banking in accordance with the provisions of this Act.

(2) The Bank shall be a body corporate by the name of the Reserve Bank of India, having perpetual succession and a common seal, and shall by the said name sue and be sued.

4. Capital of the Bank.

The capital of the Bank shall be five crores of rupees.

5. Offices, branches and agencies.

The Bank shall, as soon as may be, establish offices in Bombay, Calcutta, Delhi and Madras and may establish branches or agencies in any other place in India or, with the previous sanction of the Central Government, elsewhere.

6. Management.

(1) The Central Government may from time to time give such directions to the Bank as it may, after consultation with the Governor of the Bank, consider necessary in the public interest.

(2) Subject to any such directions, the general superintendence and direction of the affairs and business of the Bank shall be entrusted to a Central Board of Directors which may exercise all powers and do all acts and things which may be exercised or done by the Bank.

(3) Save as otherwise provided in regulations made by the Central Board, the Governor and in his absence the Deputy Governor nominated by him in this behalf, shall also have powers of general superintendence and direction of the affairs and the business of the Bank, and may exercise all powers and do all acts and things which may be exercised or done by the Bank.

The Central Board shall consist of the following Directors, namely:-

(a) a Governor and **2**[not more than four] Deputy Governors to be appointed by the Central Government;

(b) four Directors to be nominated by the Central Government, one from each of the four Local Boards as constituted by section 9;

(c) ten Directors to be nominated by the Central Government; and

(d) two Government officials to be nominated by the Central Government;

7. Local Boards, their constitution and functions.

(1) A Local Board shall be constituted for each of the four areas specified in the First Schedule and shall consist of five members to be appointed by the Central Government to represent, as far as possible, territorial and economic interests and the interests of co-operative and indigenous banks.

(2) The members of the Local Board shall elect from amongst themselves one person to be the chairman of the Board.

(3) Every member of a Local Board shall hold office for a term of four years and shall be eligible for reappointment:

Provided that any such Director shall not be appointed for more than two terms, that is, for a maximum period of eight years either continuously or intermittently.

(4) A Local Board shall advise the Central Board on such matters as may be generally or specifically referred to it and shall perform such duties as the Central Board may delegate to it.

8. Disqualifications of Directors and members of Local Boards.

(1) No person may be a Director or a member of a Local Board who -

(a) is a salaried Government official, or

(b) is, or at any time has been, adjudicated an insolvent, or has suspended payment or has compounded with his creditors, or

(c) is found lunatic or becomes of unsound mind, or

(d) is an officer or employee of any bank, or

(e) is a Director of a banking company within the meaning of clause (c) of section 5 of the [Banking Regulation Act, 1949], or of a co-operative bank.

(2) No two persons who are partners of the same mercantile firm, or are Directors of the same private company, or one of whom is the general agent of or holds a power of procuration from the other, or from a mercantile firm of which the other is a partner, may be Directors or members of the same Local Board at the same time.

(3) Nothing in clause (a), clause (d) or clause (e) of sub-section (1) shall apply to the Governor, or to a Deputy Governor, or to the Director nominated under clause (d) of sub-section (1) of section 8.

9. Meetings of the Central Board.

(1) Meetings of the Central Board shall be convened by the Governor at least six times in each year and at least once in each quarter.

(2) Any four Directors may require the Governor to convene a meeting of the Central Board at any time and the Governor shall forthwith convene a meeting accordingly.

(3) The Governor, or if for any reason, he is unable to attend, the Deputy Governor authorized by the Governor under the proviso to subsection (3) of section 8 to vote for him, shall preside at meetings of the Central Board, and, in the event of an equality of votes, shall have a second or casting vote.

12.4 Functions of central banking

The internal organizational set up of the Bank has been modified and expanded from time to time in order to cope with the increasing volume and range of Bank's activities. In order to perform its various functions, the Bank has been divided and sub divided into a large number of departments. Apart from banking and issue departments, there are at present 20 departments and three training establishments at the central office of the bank.

Functions

The Reserve Bank of India Act of 1934 entrust all the important functions of a central bank the Reserve Bank of India.

1. Issuing Authority: Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right or authority or monopoly of issuing currency notes other than one rupee notes and coins and coins of smaller denominations. Although one rupee coins and notes and coins of smaller denominations are issued by the Government of India, but put into circulation only through RBI. The currency notes issued by the Bank are legal tender everywhere in India. Apart from issuing currency and withdrawing it from circulation, it also exchanges notes and coins of one denomination into those of other denominations as demanded by public. RBI also makes adequate arrangements for holding and distributing the currency notes and coins which ensure its complete and uniform control over the credit and currency system of the economy. RBI issue notes against the security of gold coins and gold bullion, foreign securities, government securities and bills of exchange and promissory notes. The affairs of the bank relating to note issue and its general banking business are conducted through two separate departments, the Issue and Banking Department. The Issue Department is liable for the aggregate value of currency notes of Government of India and the currency notes of the Reserve Bank in circulation and it maintains eligible assets for equivalent value. It is responsible for getting its periodical requirements of notes printed from the currency presses of the Government of India, distribution of currency among the public and withdrawal of unserviceable notes and coins from circulation. The Issue Department deals directly with the public in exchange of currency for coins and vice versa and exchange of notes of one denomination for another. The expansion and contraction of currency in circulation is affected through the Banking Department. Cash deposits and withdrawals by scheduled banks are handled by the Banking Department. The Banking Department replenishes its currency when necessary from the Issue Department against transfer of eligible assets. Similarly, surplus cash is returned to the Issue Department in exchange for equivalent assets. Originally, the assets of the Issue Department were to consist of not less than two-fifths of gold coin, gold bullion or sterling securities provided the amount of gold was not less than Rs. 40 crores in value. The remaining three-fifths of the assets might be held in rupee coins, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India. Due to the exigencies of the Second World War and the post-war period, these provisions were considerably modified. Since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Ra.

200 crores, of which at least Rs. 115 crores should be in gold. The system as it exists today is known as the minimum reserve system.

2. Banker of Government: The second important function of the Reserve Bank of India is to act as banker to the Government of India statutorily and to state governments by feature of agreements entered into with them. The Reserve Bank is agent of Central Government and of all State Governments in India excepting that of Jammu and Kashmir. The Reserve Bank has the obligation to transact Government business, via. To keep the cash balances as deposits free of interest, to receive and to make payments on behalf of the Government and to carry out their exchange remittances and other banking operations. It is not entitled to any remuneration for these services. In addition to these ordinary banking operations the Reserve Bank of India helps the Government - both the Union and the States to float new loans and to manage public debt. The RBI is entitled to charge a commission for these activities. Under public debt management the RBI manages deficit/ surplus in the central and state government by providing money to fill the gap between receipts and payments. It is done in the following ways:

a. For Central Government: The deficit/ surplus in the central government account with the RBI are managed by the creation/ cancellation of ad-hoc treasury bills which are held in the Issue Department and hence the budget deficit/ surplus is monetized.

b. For State Government: The gap between receipts and payments of state governments is by

‘ways and means advances’. These advances are of three types:

a) Normal/ clean advances which are without any collateral security.
b) Secured advances are against the pledge of the central government securities.
c) Special advances are granted at the discretion of RBI.

The Bank makes ways and means advances to the Governments for 90 days. It makes loans and advances to the States and local authorities. In addition to ways and means advances, the state government also heavily uses overdrafts from the RBI. RBI is involved in underwriting government securities. It acts as a principal and as an agent in securities market. It acts as adviser to the Government on all monetary and banking matters.

3. Bankers' Bank and Lender of the Last Resort or Father of Banks: The Reserve Bank of India acts as the bankers' bank. The RBI controls the volume of reserves of the banks and determines their deposit credit creation ability. The banks hold all/ a part of their reserves with the RBI and in times of need, they borrow from the RBI. According to the provisions of the Banking Companies Act of 1949, every scheduled bank was required to maintain with the Reserve Bank a cash balance equivalent to 5% of its demand liabilities and 2 per cent of its time liabilities in India. By an amendment of 1962, the distinction between demand and time liabilities was abolished and banks have been asked to keep cash reserves equal to 3 per cent of their aggregate deposit liabilities. The minimum cash requirements can be changed by the Reserve Bank of India. The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities or get financial accommodation in times of need or stringency by rediscounting bills of exchange. Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis the Reserve Bank becomes not only the banker's bank but also the lender of the last resort.

4. Controller of Credit: The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank rate or through open market operations. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank. The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a license from the Reserve Bank of India to do banking business within India, the license can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank. As supreme banking authority in the country, the Reserve Bank of India, therefore, has the following powers:

a) It holds the cash reserves of all the scheduled banks.
b) It controls the credit operations of banks through quantitative and qualitative controls.
c) It controls the banking system through the system of licensing, inspection and calling for information.
d) It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

5. Custodian of Foreign Reserves: The RBI maintains the external value of the rupee through the regulation of foreign exchange market coupled with domestic policies. In the external sector, the task of RBI has following dimensions:

a) To administer ‘foreign exchange control’.
b) To choose the exchange rate system and fix or manage the exchange rate between the rupee and other currencies.
c) To manage exchange reserves.

d) To interact with monetary authorities of other countries and with the international financial institutions such as IMF and World Bank.

The RBI administers the exchange control according to the Foreign Exchange Maintenance Act (FEMA) to primarily regulate the demand for foreign exchange within the limits of available supply. The controls are administered through the authorized foreign exchange dealers. In the pre-liberalization era, the exchange rate of rupee was fixed in terms of 'basket of currencies'. But after the early nineties, as the rupee became fully convertible on current account, the rate has been market related. The controls on foreign exchange are being gradually relaxed. As the custodian of the foreign exchange reserves, the RBI also sees to the investment and utilization of foreign exchange reserves in the most advantageous manner.

The Reserve Bank of India has the responsibility to maintain the official rate of exchange. According to the Reserve Bank of India Act of 1934, the Bank was required to buy and sell at fixed rates any amount of sterling in lots of not less than Rs. 10,000. The rate of exchange fixed was Re. 1 = sh. 6d. Since 1935 the Bank was able to maintain the exchange rate fixed at lsh.6d. Though there were periods of extreme pressure in favour of or against the rupee. After India became a member of the International Monetary Fund in 1946, the Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the International Monetary Fund (IMF). Besides maintaining the rate of exchange of the rupee, the Reserve Bank has to act as the custodian of India's reserve of international currencies. The vast sterling balances were acquired and managed by the Bank. Further, the RBI has the responsibility of administering the exchange controls of the country.

6. Supervisory Functions: To promote a sound and effective banking system, the RBI is vested with wide ranging powers to supervise and control banks. The main powers are:

a) To issue licenses for the establishment of new banks.

b) To issue licenses for setting up of bank branches.

c) To prescribe for banks, the minimum requirements regarding capital and resources, the transfer of reserve fund and maintenance of cash reserve and other liquid assets.

d) To inspect the organizational set up: branch expansion, mobilization of deposits, investments, credit portfolio management, region wise performance, profit planning, manpower planning, training and so on regarding banks.

e) To investigate into complaints, irregularities and fraud in respect of banks.

f) To check improper investments and injudicious advances by the banks.

g) To control appointment, re-appointment, termination of chairman/ chief executive officer of private sector banks.

h) To approve/ force amalgamation.

7. Promotional Functions: With economic growth assuming a new urgency since Independence, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialized financing agencies. Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; it set up the Deposit Insurance Corporation in 1962, the Unit Trust of India in 1964, the Industrial Development Bank of India also in 1964, the Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up directly or indirectly by the Reserve Bank to promote saving habit and to mobilize savings, and to provide industrial finance as well as agricultural finance.

As far back as 1935, the Reserve Bank of India set up the Agricultural Credit Department to provide agricultural credit. But only since 1951 the Bank's role in this field has become extremely important. The Bank has developed the co-operative credit movement to encourage saving, to eliminate moneylenders from the villages and to route its short term credit to agriculture. The RBI has set up the Agricultural Refinance and Development Corporation to provide long-term finance to farmers.

8. Monetary Planning and Control Functions: The RBI regulates the availability, cost and terms and conditions of credit in the market. It aims at regulating and controlling the money supply as per the requirements of the economy and the monetary policy.

12.5 Functions of commercial banks

According to the banking regulation act-1934, a commercial bank is a financial institution whose main business is to accept deposits from the public and to give loans to those who require it for short periods. The general functions of a commercial bank, permitted by the act, may be summarized as follows:-

1. Receiving of Deposits

The most important function of the commercial banks is to receive deposits from the public. The commercial banks not only protect them but also help transfer of funds through cheques and even undertake to repay the money in legal tender money. Deposits received by the commercial banks are of various types, - fixed deposits, savings deposits, current deposits and recurring deposits. Fixed deposits or Time deposits are with the bank for a specified period of time and they can be withdrawn only after the expiry of the said period. The interest rate depends on the time agreed upon. The longer the maturity period, the higher the interest rate and vice versa. Form the point of view of safety and interest, fixed deposits are preferable. Savings deposits are those deposits received subject to certain restrictions. For instance, the interest is normally lower on savings deposits; withdrawals may be made once or twice a week.

Current deposit or demand deposits as they the often called, are those deposits withdrawable by the depositor at any time without any prior notice by means of cheques. The banks do not pay any interest on demand deposits, but in fact make a small charge on customers with current account.

Recurring deposits are those deposits received by the banks in equal monthly premium for a certain number of years the total of which will be paid to the depositor with interest due thereon after the expiry of the date of maturity.

Deposits at cal according to which deposits may be withdrawn when asked for by the depositor, deposits at short notice by which depositors are required to give notice before certain number of days (7,21,30,45 or 90) for withdrawal of deposits, short-time deposits for short period of a year or less for lower interest and retirement benefits deposits, are some of the important forms of deposits received by the commercial banks.

2. Making loans and Advances

The second principal function of the commercial bank is to make loans and advances out of the public deposits. Direct loans and advances are given to all persons against personal security, gold and silver and other movable and immovable assets. This the banks do by overdraft facilities, that is, by allowing the borrower or overdraw his current account and also by discounting bills of exchange. The merchants and manufacturers enabled to obtain adequate funds for production of goods and services. They help in the development of those industries which perform the most useful service to the community.

The loans and advances made by the commercial banks are of various forms, like cash credit, overdraft, demand loan, hire purchase loan, etc. Cash credit is that loan given by a commercial bank in installments against the security of raw materials, produced goods, etc. Overdraft is made on security against stock and shares, insurance policies, etc., under current account. Demand loan is paid in full to the debtor at a time. Hire purchase loans are made to all persons for the purchase of customer durable goods like radio, bicycle, tailoring machine, sites for buildings etc and these loans are repayable to the bank in easy installments with interest due thereon.

3. Agency Services

A commercial bank provides a range of investment services. Customers can arrange for dividends to be sent to their bank and directly remitted into their bank accounts, or for the bank to detach coupons from bearer bonds and present them for payments and to act upon announcements in the Press of drawn bonds, coupons payable, etc. Orders for the purchase or sale of stock exchange securities are executed through the banks' brokers who will also their opinions on securities or lists of securities.

Similarly, banks will make applications of behalf of their customers for allotments arising from new capital issues, pay calls as they fall due (that is, subscriptions to capital issues made over a period), and ultimately obtain the share certificate or other documents of title. On certain agreed terms the banks will allow their names to appear on approved prospectuses or other documents as bankers for the issue of new capital, they will receive applications and carry out other instructions. A commercial bank undertakes the payment of subscriptions, premier, rents and collection of cheques, bills, promissory notes etc., on behalf of its customers. It also acts as a correspondent or representative of its customers, other banks and financial corporations.

Most of the commercial banks have an executor and trustee departments; some may have affiliated companies to deal with this branch of their business. They aim to provide, before, a complete range of trustee, executor, or advisory services for a small charge. The business of banks acting as trustees, executors, administrators, etc., has continuously expanded with considerable usefulness to their customers. By appointing a bank as an executor or trustee of his will the customer secures the advantage of continuity, and avoids having to make changes; impartiality in dealing with beneficiaries and in the exercise of discretions; and the legal and specialized knowledge pertaining to executor and trustee services. When a person dies without making a will the next-of-kin can employ the bank to act as administrator and to deal with the estate in accordance with the rules relating to intestacies.

Alternatively, if a testator makes a will but fails to appoint an executor, or if an executor is unable or unwilling to act, the bank can usually undertake the administration with the consent of the persons who are immediately concerned. Banks will act solely or jointly with others in these matters, as also in the case of trustee for stocks, shares funds, properties or other investments. Under a declaration of trust, a bank undertakes the supervision of investments and distribution of income; a customer's investments can be transferred into the bank's name of control, this enabling it to act immediately upon a notice or rights issue, allotment letters, etc. Alternatively, where it is not desired to appoint the bank as nominee, these services may still be carried out by appointing the bank as attorney. Where business is included in an estate or trust, a bank will provide for its management for a limited period, pending its sale to the best advantage as a going concern or transfer to a beneficiary. Private companies wishing to set up pension funds may appoint a bank as a custodian, trustee and investment adviser, while retaining the administration of the scheme in the hands of the management of the fund. Most banks will undertake on behalf of their customers the preparation of income tax returns and claims for the recovery of overpaid tax; they also assist the customers in checking of assessments. In addition to the usual claims involving personal allowances and reliefs, claims are prepared on behalf of residents abroad, minors, charities, etc.

4. General Utility Services

These services are those in which the bankers position in not that of an agent for his customer. They include the issue of credit instruments like letters of credit and travellers' cheques, the acceptance of bills of exchange, the safe custody of valuables and documents, the transaction of foreign exchange business, acting as a referee as to the respectability and financial standing of customers and providing specialized advisory service to customers.

By selling drafts or orders and by issuing letters of credit, circular notes, travellers' cheques, etc., a commercial banker is discharging a very important function. A banker's draft is an order, addressed by one office of a bank to any other of its branches or by any one bank to another, to pay a specified sum to the person concerned. A letter of credit is a document issued by a banker, authorizing some other banker to whom it si addressed, to honour the cheques of a person named in the document, to the extent of a stated amount in the letter and to charge the same to the account of the grantor of the letter of credit A letter of credit includes a promise by the issuing banker to accept all bills to the limits of credit. When the promise to accept is conditional on the receipt of the documents of title to goods, it is called a documentary letter of credit. But the banker will still be liable for bills negotiated before the expiry of the period of its currency. 'Circular letter of Credit' is generally intended for travelers who may require money in different countries. They may be divided into travelers letters of credit and guarantee letters of credit. A travelers letter of credit carries the instruction of the issuing bank to its foreign agents to honour the beneficiary's drafts, Cheques, etc., to a stated amount which it undertakes to meet on presentation. While issuing guarantee letters of credit, the banker secures a guarantee for reimbursement at an agree rate of interest or the may insist on sufficient security for the grant of the credit, the banker secures a guarantee for reimbursement at an agreed rate of interest or he may insist on sufficient security for the grant of the credit. There is yet another type which is known as 'Revolving Credit.' Here the letter is so worded that the amount of credit available automatically reverts to the original amount after the bills negotiated under them are duly honored.

Circular Notes are cheques on the issuing baker for certain round sums in his own currency. On the reverse side of the circular note is a letter addressed to the agents specifying the name of the holder and referring to a letter of indication in his hands, containing an specimen signature of the holder. The not will not be honource unless the letter of indication is presented. Travellers' cheques are documents similar to circular notes with the exception that they are not accompanied by any letter of indication. Circular cheques are issued by banks in certain countries to their agents abroad. These agents sell them to intending visitors to the country of the issuing bank.

Another important service rendered by a modern commercial bank is that of keeping in safe custody valuables such as negotiable securities, jewellery, documents of title, wills, deed-boxes, etc., Some branches are also equipped with specially constructed strong rooms, each containing a large number of private steel safes of various sizes. These may be used by non-customers for a small fee as well as by regular customers. Each licensee in provided with the key of an individual safe and thus not only obtains protection for his valuables, but also retains full personal control over them. The safes are accessible at any time during banking hours and often longer. For shopkeepers and other customers who handle large sums of money after banking hours. 'night safes' are available at many banks. Night safe takes the form of a small metal door in the outside wall of the bank, accessible from the street, behind which there is a chute connecting with the bank's strong room. Customers who require this service are provided with a leather wallet, which they lock before placing in the chute. The wallet is opened by the customer when he calls at the bank the next day to pay the contents into his account.

Another function of great value, both to bankers and to businessman, is that of a referee as to the respectability a financial status of the customer.

Among the services introduced by modern commercial banks during the last quarter of a century or so, the bank giro and credit cards deserve special mention. The bank giro is a system by which a bank customer with many payments to make, instead of drawing a cheque for each item, may simply instruct his bank to transfer to the bank accounts of his creditor the sum due from him, and he writes one cheque debiting his account with the total amount. Credit advices containing the name of each creditor with the name of his bank and the branch will be cleared through the ‘credit clearing’ of the clearing-house, which operates in a similar way as for the clearing of cheques. Even non-customers of a bank for a small charge may make use of this facility. A direct debiting service is also operated by some banks, This service is designed to assist organizations which receive large number of payments on a regular basis. A creditor is thereby enabled with the prior approval of the debtor, to claim any money due to him direct from the debtor’s bank account. To some organizations, for example, insurance companies, which receive, say, six equal sums on six dated in a year, the scheme is only an ‘extension of the standing order facility; but for the public utilities and traders which send out invoices for variable amounts at differing times, the scheme is an entirely new one.

Credit cards are introduced for the use of credit-worthy customers. Users are issued with a card on production of which their signature is accepted on bills in shops and establishments participating in the scheme. The banks thereby guarantee to meet the bill and recover from the cardholders through a single account presented periodically. In some cases uses are required to pay a regular subscription for the use of the service as well. An extension of the scheme allows the repayment of large sums (subject to a maximum) over a period at interest.

Some banks are opening budget accounts for credit-worthy customers. The bank guarantees to pay, for a specific charge, certain types of annual bills (for example, fuel bills, rates, etc.) promptly as they become due, whilst repayments are spread over a 12-monthly period from the customer's current account.

All these new money transmission services have particular regard to the developments in computerized book-keeping which the banks in some countries have already introduced. Some banks are reported to be experimenting with the use of electronic machines which will scan cheques and dispense notes or coins, thus saving time at the counter.

5. Overseas Treading Services

Recognition of overseas trade has led modern commercial banks to set up branches specializing in the finance of foreign trade and some banks in some countries have taken interest in export houses and factoring organizations. Assisted by banks affiliated to them in overseas territories, they are able to provide a comprehensive network of services for foreign banking business, and may transactions can be carried through from start to finish by a home bank or its subsidiary. In places where banks are not directly represented by such affiliated undertakings, they have working arrangements with correspondents so that banks are in a position to undertake foreign banking business in any part of the world.

The banks provide more than just a means for the settlements of debts between trades both at home and abroad for the goods they buy and sell; they are also providers of credit and enable the company to release the capital which would otherwise be tied up in the goods exported.

6. Information and other Services

As part of their comprehensive banking services, many banks act as a major sources of information on overseas trade in all aspects. Some banks produce regular bulletins on trade and economic conditions at home and abroad, and special reports on commodities and markets. In some cases they invite enquiries for those wishing to extend their foreign trade, and are able through their correspondents to furnish the names of reputable and interested dealers of goods and commodities and to advise on the appointment of suitable agents. For businessmen traveling abroad letters of introduction, indicating the purpose of journey taken, can be issued addressed to banking correspondents in the various centers it is proposed to visit. In this way it is often possible to establish new avenues of business. On request, banks obtain for customers, for business houses, confidential opinions on the financial standing of companies, firms or individuals at home or overseas.

Commercial banks furnish advice and information outside the scope merely of trade. If it is desired to set up a subsidiary or branch overseas (or for an overseas company to set up in the home country) they help to establish contracts with local banking organizations.

To sum up, the service rendered by a modern commercial bank is of inestimable value. It mobilizes the scattered saving of the community and redistributes them into more useful channels. It enables large payments to be made over long distances with maximum expenses. It constitutes the very life blood of an advanced economic society. In the words of Walter Leaf: “The banker is the universal arbiter of the world’s economy.”

12.6 RECENT DEVELOPMENT IN BANKING REGULATION ACT.1934

1. The India and Burma (Burma Monetary Arrangements) Order, 1937.

2. The Repealing and Amending Act, 1937 (20 of 1937).

3. The Reserve Bank of India (Amendment) Act, 1940 (9 of 1940).

4. The Reserve Bank of India (Second Amendment) Act, 1940 (13 of 1940).

5. The Currency Ordinance, 1940 (Ord. 4 of 1940).

6. The Reserve Bank of India (Third Amendment) Act, 1940 (38 of 1940).

7. The Reserve Bank of India (Amendment) Ordinance, 1941 (Ord. 3 of 1941).

8. The International Monetary Fund and Bank Ordinance, 1945 (Ord. 47 of 1945).

9. The Reserve Bank of India (Amendment) Act, 1946 (23 of 1946).

10. The Reserve Bank of India (Amendment) Act, 1947 (11 of 1947).

11. The Reserve Bank of India (Second Amendment) Act, 1947 (23 of 1947).

12. The Repealing and Amending Act, 1947 (2 of 1948).

13. The Indian Independence (Adaptation of Central Acts and Ordinances) Order, 1948.

14. The Reserve Bank (Transfer to Public Ownership) Act, 1948 (62 of 1948).

15. The Banking Companies Act, 1949 (10 of 1949).

16. The Repealing and Amending Act, 1949 (40 of 1949).

17. The Reserve Bank of India (Amendment) Act, 1949 (44 of 1949).

18. The Adaptation of Laws Order, 1950.

19. The Reserve Bank of India (Amendment) Act, 1951 (32 of 1951).

20. The Reserve Bank of India (Amendment and Miscellaneous provisions) Act, 1953 (54 of 1953).

21. The Andhra (Adaptation of Laws on Union Subjects) Order, 1954.

22. The State Bank of India Act, 1955 (23 of 1955).

23. The Reserve Bank of India (Amendment) Act, 1955 (24 of 1955).

24. The Agricultural Produce (Development and Warehousing) Corporations Act, 1956 (28 of 1956). 25. The States Reorganisation Act, 1956 (37 of 1956).

26. The Reserve Bank of India (Amendment) Act, 1956 (38 of 1956).

27. The Jammu and Kashmir (Extension of Laws) Act, 1956 (62 of 1956).

28. The State Bank of Hyderabad Act, 1956 (79 of 1956).

29. The Adaptation of Laws (No.3) Order, 1956.

30. The Reserve Bank of India (Amendment) Act, 1957 (19 of 1957).

31. The Reserve Bank of India (Second Amendment) Act, 1957 (48 of 1957).

32. The Reserve Bank of India (Amendment) Act, 1959 (14 of 1959).

33. The Banking Companies (Amendment) Act, 1959 (33 of 1959).

34. The State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959).

35. The Reserve Bank of India (Amendment) Act, 1960 (14 of 1960).

36. The Repealing and Amending Act, 1960 (58 of 1960).

37. The Bombay Reorganisation (Adaptation of Laws on Union Subjects) Order, 1961.

38. The Deposit Insurance Corporation Act, 1961 (47 of 1961).

39. The Goa, Daman and Diu (Currency and Coinage) Regulation, 1962 (Reg. 6 of 1962).

40. The Reserve Bank of India (Amendment) Act, 1962 (35 of 1962).

41. The Agricultural Refinance Corporation Act, 1963 (10 of 1963).

42. The Unit Trust of India Act, 1963 (52 of 1963).

43. The Banking Laws (Miscellaneous Provisions) Act, 1963 (55 of 1963).

44. The Pondicherry (Laws) Regulation, 1963 (Reg. 7 of 1963).

45. The Industrial Development Bank of India Act, 1964 (18 of 1964).

46. The Banking Laws (Application to Co-operative Societies) Act, 1965 (23 of 1965).

47. The State of Nagaland (Adaptation of Laws on Union Subjects) Order, 1965.

48. The Unit Trust of India (Amendment) Act, 1966 (17 of 1966).

49. The Banking Laws (Amendment) Act, 1968 (58 of 1968).

50. The Punjab Reorganisation and Delhi High Court (Adaptation of Laws on Union Subjects) Order, 1968.

51. The Assam Reorganisation (Meghalaya) Act, 1969 (55 of 1969).

52. The Madras State (Alteration of Name) (Adaptation of Laws on Union Subjects) Order, 1970.

53. The Agricultural Refinance Corporation (Amendment) Act, 1971 (39 of 1971). 54. The North-Eastern Areas (Reorganisation) Act, 1971 (81 of 1971).

55. The State of Himachal Pradesh (Adaptation of Laws on Union Subjects) Order, 1973.

56. The Reserve Bank of India (Amendment) Act, 1973 (44 of 1973).

57. The North-Eastern Areas (Reorganisation) (Adaptation of Laws on Union Subjects) Order, 1974.

58. The Mysore State (Alteration of Name) (Adaptation of Laws on Union Subjects) Order, 1974.

59. The Laccadive, Minicoy and Amindivi Islands (Alteration of Name) Adaptation of Laws Order, 1974.

60. The Reserve Bank of India (Amendment) Act, 1974 (51 of 1974).

61. The Public Financial Institutions Laws (Amendment) Act, 1975 (52 of 1975).

62. The Regional Rural Banks, Act, 1976 (21 of 1976).

63. The Deposit Insurance Corporation (Amendment and Miscellaneous Provisions) Act, 1978 (21 of 1978).

64. The Reserve Bank of India (Amendment) Act, 1978 (24 of 1978).

65. The Export-Import Bank of India Act, 1981 (28 of 1981).

66. The National Bank for Agricultural and Rural Development Act, 1981 (61 of 1981).

67. The Banking Laws (Amendment) Act, 1983 (1 of 1984).

68. The Industrial Reconstruction Bank of India Act, 1984 (62 of 1984).

69. The Banking Laws (Amendment) Act, 1985 (81 of 1985).

70. The National Housing Bank Act, 1987 (53 of 1987).

71. The Banking Public Financial Institutions and Negotiable Instruments Laws (Amendment) Act, 1988 (66 of 1988).

72. The Small Industries Development Bank of India Act, 1989 (39 of 1989).

73. The Reserve Bank of India (Amendment) Act, 1991 (8 of 1991).

74. The Reserve Bank of India (Second Amendment) Act, 1991 (9 of 1991).

75. The Reserve Bank of India (Amendment) Act, 1997 (23 of 1997).

76. The Information Technology Act, 2000.

77. Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003 (Act No. 53 of 2003)

78. Credit Information Companies (Regulation) Act, 2005 (Act No. 30 of 2005) 79. Reserve Bank of India (Amendment) Act, 2006 (Act No. 26 of 2006).

80. Securities and Insurance Laws (Amendment and Validation) Act, 2010 (Act No. 26 of 2010).

81. The Factoring Regulation Act, 2011 (Act No. 12 of 2012).

82. The Banking Laws (Amendment) Act, 2012 (Act No. 4 of 2013).

12.7 SUMMARY

The earliest attempts to set up a central bank dates back to 1773, later on in 1921, by amalgamating three presidency Banks (Presidency Bank of Bengal, Presidency Bank of Madras and Presidency Bank of Bombay), Imperial Bank of India was set up. Thus, the Reserve Bank of India started working since, 1st April, 1935 in accordance with the provision of the Reserve Bank of India Act, 1934. The Bank began its operations by taking over from the Government the functions so far being performed by the Controller of Currency and from the Imperial Bank of India, the management of Government accounts and public debt. The Reserve Bank of India Act of 1934 assigns all the important functions of a central bank the Reserve Bank of India. Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right or authority or monopoly of issuing currency notes other than one rupee notes and coins and coins of smaller denominations. In addition to these ordinary banking operations the Reserve Bank of India helps the Government - both the Union and the States to float new loans and to manage public debt. The Reserve Bank of India acts as the bankers' bank. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Every bank has to get a license from the Reserve Bank of India to do banking business within India, the license can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialized financing agencies. Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; it set up the Deposit Insurance Corporation in 1962, the Unit Trust of India in 1964, the Industrial Development Bank of India also in 1964, the Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972.

12.8 KEYWORDS

Central Banking : Central Bank is an top financial institution to regulate and control the monetary system of an economy.

Monetary Stability : The stability in the value of money in country and abroad.

Issuing Authority: The sole right or authority or monopoly of issuing currency and notes.

Lender of the Last Resort : The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities or get financial accommodation in times of need.

12.9 REVIEW QUESTIONS

1. What do you mean by banking regulation also state the objectives of banking regulation?
2. Explain in detail the features of the banking regulation act.1934?
3. What are the functions expected from a RBI according to the banking regulation act.1934?
4. What are the functions expected from a commercial banks according to the banking regulation act.1934?
5. Give details about the recent development in banking regulation act.1934?

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