Q.No.1 Define commercial bank and describe its functions

Functions of Commercial Banks:

Commercial banks perform a variety of functions which can be divided as: These functions are discussed as follows:

1. Accepting Deposits:

This is the oldest function of a bank and the banker used to charge a commission for keeping the money in its custody when banking was developing as an institution. Nowadays a bank accepts three kinds of deposits from its customers. The first is the savings deposits on which the bank pays small interest to the depositors who are usually small savers.

2. Advancing Loans:

One of primary functions of commercial banks is to advance loans to its customers. A bank lends a certain percentage of the cash lying in deposits on a higher interest rate than it pays on such deposits. This is how it earns profits and carries on its business. The bank advances loans in the following ways:

(a) Cash Credit:

The bank advances loan to businessmen against certain specified securities. The amount of the loan is credited to the current account of the borrower. In cash of a new customer a loan account for the sum is opened. The borrower can withdraw money through cheques according to his requirements buy pays interest on the full amount.

(b) Call Loans:

These are very short-term loans advanced to the bill brokers for not more than fifteen days. They are advance against first class bill or securities. Such loans can be recalled at a very short notice. In normal times they can also be renewed.

(c) Overdraft:

A bank often permits a businessman to draw cheques for a sum greater than the balance laying in his Current account. This is done by providing the overdraft facility up to a specific amount to the businessman. But he is charged interest only on the amount by which his current account is actually overdrawn and not by the full amount of the overdraft sanctioned to him by the banks.

(d) Discounting Bills of Exchange:

If a creditor holding a bill of exchange wants money immediately, the bank provides him the money by discounting the bill of exchange. It deposits the amount of the bill in the current account of the bill-holder after deducting its rate of interest for the period of the loan which is not more than 90 days. When the bill of exchange matures, the bank gets its payment from the banker of the debater who accepted the bill.

3. Credit Creation:

Credit creation is one of the most important functions of the commercial banks. Like other financial institutions, they aim at earning profits. For this purpose, they accept deposits and advance loans by keeping small cash in reserve for day-to-day transactions. When a bank advances a loan, it opens and account in the name of the customer and does not pay him in cash but allows him to draw the money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.

4. Financing Foreign Trade:

A commercial bank finances foreign trade of its customers by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and buys and sells foreign currency.

5. Agency Services:

A bank acts as an agent of its customers in collecting and paying cheques, bills of exchange, drafts, dividends, etc. It also buys and sells shares, securities, debentures, etc. for its customers. Further, it pays subscriptions, insurance premium, rent, electric and water bills, and other similar charges on behalf of its clients. It also acts as a trustee and executor of the property and will of its customers. Moreover, the bank acts as an income tax consultant to its clients. For some of these services, the bank charges a normal fee while it renders others free of charge.

6. Miscellaneous Services:

Besides the above noted services, the commercial bank performs a number of other services. It acts as the custodian of the valuables of its customers by providing those lockers where they can keep their jewelry and valuable documents. It issues various forms of credit instruments, such as cheques, drafts, travelers cheques, etc. which facilitate transactions.

The bank also issues letter of credit and acts as a referee to its clients. It underwrites shares and debentures of companies and helps in the collection of funds from the public. Some commercial banks also publish journal which provide statistical information about the money market and business trends of the economy.

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Q.No.2

Role of Commercial bank in Economic development

1. Mobilizing Saving for Capital Formation:

The commercial banks help in mobilizing savings through network of branch banking. People in developing countries have low incomes but the banks induce them to save by introducing variety of deposit schemes to suit the needs of individual depositors. They also mobilize idle savings of the few rich. By mobilizing savings, the banks channelize them into productive investments. Thus they help in the capital formation of a developing country.

2. Financing Industry:

The commercial banks finance the industrial sector in a number of ways. They provide short-term, medium-term and long-term loans to industry. In India they provide short-term loans. Income of the Latin American countries like Guatemala, they advance medium-term loans for one to three years. But in Korea, the commercial banks also advance long-term loans to industry.

In Pakistan, the commercial banks undertake short-term and medium-term financing of small scale industries, and also provide hire- purchase finance. Besides, they underwrite the shares and debentures of large scale industries. Thus they not only provide finance for industry but also help in developing the capital market which is undeveloped in such countries.

3. Financing Trade:

The commercial banks help in financing both internal and external trade. The banks provide loans to retailers and wholesalers to stock goods in which they deal. They also help in the movement of goods from one place to another by providing all types of facilities such as discounting and accepting bills of exchange, providing overdraft facilities, issuing drafts, etc. Moreover, they finance both exports and imports of developing countries by providing foreign exchange facilities to importers and exporters of goods.

4. Financing Agriculture:

The commercial banks help the large agricultural sector in developing countries in a number of ways. They provide loans to traders in agricultural commodities. They open a network of branches in rural areas to provide agricultural credit. They provide finance directly to agriculturists for the marketing of their produce, for the modernization and mechanization of their farms, for providing irrigation facilities, for developing land, etc.

5. Financing Consumer Activities:

People in underdeveloped countries being poor and having low incomes do not possess sufficient financial resources to buy durable consumer goods. The commercial banks advance loans to consumers for the purchase of such items as houses, scooters, fans, refrigerators, etc. In this way, they also help in raising the standard of living of the people in developing countries by providing loans for consumptive activities.

6. Financing Employment Generating Activities:

The commercial banks finance employment generating activities in developing countries. They provide loans for the education of young person's studying in engineering, medical and other vocational institutes of higher learning. They advance loans to young entrepreneurs, medical and engineering graduates, and other technically trained persons in establishing their own business. Such loan facilities are being provided by a number of commercial banks in India. Thus the banks not only help inhuman capital formation but also in increasing entrepreneurial activities in developing countries.

7. Help in Monetary Policy:

The commercial banks help the economic development of a country by faithfully following the monetary policy of the central bank. In fact, the central bank depends upon the commercial banks for the success of its policy of monetary management in keeping with requirements of a developing economy.

Thus the commercial banks contribute much to the growth of a developing economy by granting loans to agriculture, trade and industry, by helping in physical and human capital formation and by following the monetary policy of the country.

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Question No. 3

Definition of a Cheque and Different Kinds / Types of Cheques.

"Cheque is an instrument in writing containing an unconditional order, addressed to a banker, sign by the person who has deposited money with the banker, requiring him to pay on demand a certain sum of money only to or to the order of certain person or to the bearer of instrument."

Cheque is an important negotiable instrument which can be transferred by mere hand delivery. Cheque is used to make safe and convenient payment. It is less risky and the danger of loss is minimized.

Different Kinds / Types of Cheques ↓

1. Bearer Cheque

When the words "or bearer" appearing on the face of the cheque are not cancelled, the cheque is called a bearer cheque. The bearer cheque is payable to the person specified therein or to any other else who presents it to the bank for payment. However, such cheques are risky, this is because if such cheques are lost, the finder of the cheque can collect payment from the bank.

2. Order Cheque

When the word "bearer" appearing on the face of a cheque is cancelled and when in its place the word "or order" is written on the face of the cheque, the cheque is called an order cheque. Such a cheque is payable to the person specified therein as the payee, or to any one else to whom it is endorsed (transferred).

3. Uncrossed / Open Cheque

When a cheque is not crossed, it is known as an "Open Cheque" or an "Uncrossed Cheque". The payment of such a cheque can be obtained at the counter of the bank. An open cheque may be a bearer cheque or an order one.

4. Crossed Cheque

Crossing of cheque means drawing two parallel lines on the face of the cheque with or without additional words like "& CO." or "Account Payee" or "Not Negotiable". A crossed cheque cannot be encashed at the cash counter of a bank but it can only be credited to the payee's account.

5. Anti-Dated Cheque

If a cheque bears a date earlier than the date on which it is presented to the bank, it is called as "anti-dated cheque". Such a cheque is valid up to three months from the date of the cheque.

6. Post-Dated Cheque

If a cheque bears a date which is yet to come (future date) then it is known as post-dated cheque. A postdated cheque cannot be honored earlier than the date on the cheque.

7. Stale Cheque

If a cheque is presented for payment after three months from the date of the cheque it is called stale cheque. A stale cheque is not honoured by the bank.

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Question No.4

What is Central Bank and also discussed its role in economics development

<u>Introduction:</u>

The first central bank was established in Geneva in 1578. After the World War I, a conference was held in Brussels in 1920 and it was decided that every country must set up its central bank.

CENTRAL BANK

"Central bank is a special institution whose customers are commercial banks and state."

<u>According to R. P. Kent:</u>

"An institution that is charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of the general public welfare."

<u>State Bank of Pakistan:</u>

Central bank of Pakistan is the "State Bank of Pakistan". State bank of Pakistan was established on 1st July 1948. Quaid-i-Azam Muhammad Ali Jinah performed its opening ceremony. Now, it is working under the State Bank of Pakistan Act 1956.

ECONOMIC DEVELOPMENT

Definition:

"It refers to the process whereby the total supply of goods and services of the society increases leading towards improved living standards."

According to Micheal P. Todaro:

"Development must be conceived for as a multi-dimensional process involving major change in social structures, popular attitudes and national institutions as well as the acceleration of eco-growth, the eradication of poverty and reduction of inequality of wealth."

ROLE OF STATE BANK / IMPORTANCE IN ECONOMIC DEVELOPMENT

State bank of Pakistan plays an important role in the process of economic development, which is clear from the following points:

Issue of Notes

State bank of Pakistan has monopoly in issuing currency notes. 5, 10, 50, 100 rupee notes are issued by the bank on 12 July 1976. Note of 500 rupee was issued on 1st April 1986 and 1000 rupee note was issued on 18th July 1987. At present note of Rs.5000 is also issued by the state bank of Pakistan. The state bank has three offices of issue, situated at Karachi, Lahore and Peshawar.

Banker to the Government

It is the bank of federal as well as provincial government. Its functions for the Govt. are:
Bank issued new notes on the behalf of government

Bank also accepts the government cheques and drafts State bank responsible for transferring government funds at international level

Bank arranges the public debts of federal and provincial government

Bank receives no commission form the government

It holds federal and provincial government securities
State bank is liable for the payment of salaries and pension to government employees

Banker's Bank

State bank of Pakistan is the bank of all commercial banks working in Pakistan. SBP started to spend $ 24.00 million in October 2002, with the assistance of World Bank for data warehousing, networking, application of software and other banking solutions.
State bank provides loans to commercial banks at the time of need
Commercial banks re-discount their bills of exchange from state bank
State bank can sell, purchase and hold debentures of any banking company or of any other financing corporation

Clearing House

State bank of Pakistan acts as the clearing-house for the commercial banks working within the country. It shows the financial position of various banks.

Clearing-house helps commercial banks to settle inter-bank transactions
It reduces the excessive use of cash
It controls the harmful competition among banks

Advisor to Government

State bank of Pakistan works as an advisor to federal and provincial government.
It guides the government in financial and economic matters
State bank assists the government in various credit schemes

It informs the government about the monetary and fiscal situations of economy
State bank helps the government in making investments

Lender of Last Resort

The state bake of Pakistan also acts as the lender of the last resort for the commercial banks. When commercial banks are in crisis and have shortage of cash, then state bank comes to their help. State bank may help the commercial banks by rediscounting their bills of exchange and by advancing loans against securities.

Controller of Credit

A national credit consultative council was setup in 1972 for the purpose of monitoring and controlling credit. Credit and investment are the most important economic and fiscal variable. State bank helps to arrange the credit and investment facilities. State bank has adopted following tools to control credit:

Open market operation

- Bank rate policy
- Changes in reserves ratio
- Changes in margin requirements
- Change in liquidity ratio
- Moral persuasion and publicity

Economic Growth

State bank of Pakistan played a very significant role in the growth of the banking infrastructure. It gives special importance towards the development of capital market in the country. It also provides assistance to the government in development planning and poverty reduction programmes. All this results in economic growth and development. Real GDP growth rate is 2.4 % during FY 2010-11.

Growth of Credit Institutions

State bank develops the atmosphere for the development of credit institutions. Such credit institutions are very useful for meeting medium and long-term credit needs of various economic sectors. These institutions are included HBFC, ICP, NDFC, EPF, NIT, IDBP & ZTBL etc.

Growth of Money Market

Money market is not at its best level in Pakistan. Due to illiteracy banking situations are not favourable. State banks give much importance in the growth and development of money market. Economic development is impossible without the growth of money market. Growth rate of banking sector is 17.0%.

Value of Rupee

State bank of Pakistan is responsible for the maintenance of the external value of rupee. State bank is the controller of exchange rate in the country. Till September 1971, Pakistani rupee remained linked to UK Pound and it was de-linked from pound and linked to US Dollar.

Special Funds for Development

The major aim of state bank is not to earn profit. But its effective working gives him huge amount of profit. These profits are allocated towards establishment of various funds for economic progress and prosperity. It established Rural Credit Fund in 1961 and Export Credit Fund in 1972.

Debts Management

Our scarce resources and government policies are not able to run the mega projects which needed heavy amount of resources. Due to shortage of resources government has to depend upon other rich nations. All these arrangement are the responsibility of the state bank on the behalf of government.

Foreign Exchange Reserves

State bank of Pakistan is also the custodian of gold, silver and foreign exchange reserves. It regulates foreign exchange reserve in accordance with foreign exchange Act 1947. Pakistan has shortage in foreign exchange reserves. Its volume of foreign exchange reserves is only $12.34 billion in 2007-08. In July 2007, foreign exchange reserves were $15.646 billion out of which state bank of Pakistan has $ 4.3213 billion. At present foreign exchange reserves of Pakistan are $ 17.1 billion.

Exchange Centre

State bank issued licenses to different commercial banks to hold foreign exchange. Such license holders can also deal in foreign exchange at authorized rates. These exchange centres are very helpful in mobilizing the resources.

International Relations

State bank of Pakistan maintains relations with different international financial institutions such as IMF, WBG, etc. It negotiates different contracts with these institutions on the behalf of government.

Economic Information

State bank collects the information all over the country and world throughout the year. It also annually published its report, which is an extremely important document. This exact information is very helpful in making economic planning which is necessary for the economic development.

Conclusion:

All above points are showing that state bank of Pakistan has an important position in our economic and financial infrastructure. Without an effective role of state bank, economic development is impossible.

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Question No.5

What are negotiable Credit Instruments and its kinds?

"A **negotiable instrument** is a document which promises the payment of a fixed amount of money and may be transferred from person to person"

Followings are main kind of the negotiable instruments.

1-Cheque:

A cheque is defined by Section 6 of the Negotiable Instrument Act as “a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand”. In other words it is a bill of exchange drawn on a banker which is payable on demand.

2. Bills of Exchange:

A bill of exchange has been defined under section 5 of the Negotiable Instrument Act as “an instrument in writing containing an unconditional order, signed by the banker directing a certain person to pay certain sum of money, only to or to the order of the certain person or to the bearer of instrument. A bill of exchange may be (a) inland (b) external or foreign bill. The former bill is a bill which is payable in Pakistan. The latter means a bill payable either to foreigner or by foreigner. It is very important instrument. Without making actual payment, goods can be purchased. Secondly in foreign trade, it enables an exporter to get value for his export in his own currency.

3. Promissory Note:

A promissory note is defined by Section 4 of the Negotiable Instrument Act as “an instrument in writing (not being a bank note or currency note) containing an unconditional undertaking signed by the maker to pay a certain person or to the bearer of the instrument”.

Promissory notes are commonly used and these may be termed as credit instrument A businessmen borrowing from a bank customarily gives the bank such a note. Sellers of goods and services may accept such a note instead of cash Individuals who borrow for person needs usually give promissory notes to tenders.

4. Drafts:

These are bills of exchange issued by a banker on his branch office. Same rules are applicable as are applicable to the cheques. Bank drafts like bills of exchange are of great in pretence in the financing of trade, especially foreign trade.

5. Hundies:

These are bills of exchange in Vernacular Language, which have been in common use in our country for purpose of business from at least the 10th century A.D and which have been recognized by law as valid and effective negotiable instrument.

6. Letters of Credit:

IT is a letter written by one person or bank to another requesting the latter to pay any amount of money up to certain limit to the person named in the letter or in whose favour the letter is written. In this letter generally a date is fixed up to which only advances should be made by the addresses. Thus a letter of credit remains in force up to a certain date only. Generally these letters are issued by banks.

7. Circular Letters of Credit:

This letter is different from the letter of credit for it is addressed to several branches of the issuing banker. The amount of credit can be taken in cash or against bill of exchange drawn, which depends upon the condition of letter. The addresses are required to inscribe on the bank of the letter all advances that they make.

8**. Travelers**

Cheque: Such cheques are very useful to tourists or travelers, for against delivery of these, holders can obtain funds from any branch. Every cheque is of a fixed amount already printed on it. The cheque form has a place where the grantee has to sign in the presence of the payee banks. When these cheques are granted by issuing banker, the grantee is asked to sign all these cheques in his presence. This enables the paying banker to compare the signatures and ascertain that the payment is made to the sight person.

9. Treasury Bills:

In sub-continent, for the first time, these bills were issued by the Government on 5 November 1790 to raise money for war purposes and are issued even now. Then they were made also legal tender for all payments to the Government.

10. Book Credit:

Book credit are effected when a tradesman sells on credit or a bank advances money, the sale or advance being entered into the account books for the tradesman or of the bankers.

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Question No.6

Define Bank Advances and also discussed its principles?

Nearly all **bank** loans are made at interest, meaning borrowers pay a certain percentage of the principal amount to the lender as compensation for borrowing. Most loans also have a maturity date, by which time the borrower must have repaid the loan. A **bank** loan occasionally is called a **bank advance**.

Principles of lending:

1. Liquidity:

Liquidity is an important principle of bank lending. Bank lend for short periods only because they lend public money which can be withdrawn at any time by depositors. They, therefore, advance loans on the security of such assets which are easily marketable and convertible into cash at a short notice. A bank chooses such securities in its investment portfolio which possess sufficient liquidity. It is essential because if the bank needs cash to meet the urgent requirements of its customers,

2. Safety:

The safety of funds lent is another principle of lending. Safety means that the borrower should be able to repay the loan and interest in time at regular intervals without default. The repayment of the loan depends upon the nature of security, the character of the borrower, his capacity to repay and his financial standing.

3. Diversity:

In choosing its investment portfolio, a commercial bank should follow the principle of diversity. It should not invest its surplus funds in a particular type of security but in different types of securities. It should choose the shares and debentures of different types of industries situated in different regions of the country. The same principle should be followed in the case of state governments and local bodies. Diversification aims at minimizing risk of the investment portfolio of a bank.

4. Stability:

Another important principle of a bank's investment policy should be to invest in those stocks and securities which possess a high degree of stability in their prices. The bank cannot afford any loss on the value of its securities. It should, therefore, invest it funds in the shares of reputed companies where the possibility of decline in their prices is remote.

Profitability:

This is the cardinal principle for making investment by a bank. It must earn sufficient profits. It should, therefore, invest in such securities which was sure a fair and stable return on the funds invested. The earning capacity of securities and shares depends upon the interest rate and the dividend rate and the tax benefits they carry.

It is largely the government securities of the center, state and local bodies that largely carry the exemption of their interest from taxes. The bank should invest more in such securities rather than in the shares of new companies which also carry tax exemption. This is because shares of new companies are not safe investments.

Principle of Purpose –

At the time of granting an advance the banker must ask about the purpose of the loan. If it is for unproductive purposes, then there is less chances of repayment of loan. On the other hand, if it is for productive purposes then there are more chances of repayment loan value with the interest.

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Question No.7

What is Exchange control and also discussed its Methods of exchange control.

The various methods of exchange control may broadly be classified into two types, direct and indirect. Direct methods of exchange control include those devices which are adopted by governments to have an effective control over the exchange rate, while indirect methods are designed to regulate international movements of goods.

There are many ways to introduce exchange control in an economy. These are usually classified into two groups:

(i) Direct Exchange Control and

(ii) Indirect Exchange Control.

Direct Methods of Exchange Control:

In direct exchange control, certain measures are adopted which effectuate immediate direct restriction on foreign exchange from all sides - its quantum, use and allocation.

In general, direct exchange control includes measures like:

(i) Intervention;

(ii) Exchange restrictions;

(iii) Exchange clearing agreements;

(iv) Payment agreements; and

(v) Gold policy.

Intervention:

It refers to the government's intervention or interference in the free working of the exchange market with a view to overvalue or undervalue the country's currency in terms of foreign money.

The government or its agency - the central bank - can intervene in the free market by resorting to buying and selling the home currency against foreign currency in the foreign exchange market to support or depress the exchange rate of its currency.

Pegging Operations:

Government intervention in the foreign exchange market takes the form of the currency of the country to a chosen rate pegging down or pegging up of exchange. Since undervaluation or overvaluation is not the equilibrium rate, it has to be pegged. Thus, pegging means keeping a fixed exchange value of a currency; however, intervention may be practised by a government without resorting to pegging as such.

Pegging operations take the form of buying and selling of the local currency by the central bank of a country in exchange for the foreign currency in the foreign exchange market, in order to maintain an exchange rate whether, it is overvalued or undervalued.

Pegging up means pegging down. or pegging up. Thus, pegging may be holding fixed overvaluation, i.e., to maintain the exchange rate at a higher level. Pegging down means holding fixed undervaluation, i.e., to maintain the exchange rate at a lower (depressed) level. In the case of pegging up, the central bank shall have to keep itself ready to buy unlimited amount of local currency in exchange for foreign currencies at a fixed rate, because overvaluation tends to increase the demand for foreign currencies by creating import surplus.

Exchange Restrictions:

Exchange restrictions refer to the policy or measures adopted by a government which restrict or compulsory reduce the flow of home currency in the foreign exchange market. Exchange restrictions may be of three types:

(i) The government may centralise all trading in foreign exchange with itself or a central authority, usually the central bank; (ii) the government may prevent the exchange of local currency against foreign currencies without its permission; (iii) the government may order all foreign exchange transactions to be made through its agency.

Exchange restrictions may take various forms, the most common of them being: (1) Blocked accounts, (2) Multiple exchange rates.

Blocked Accounts:

Under the condition of severe financial crisis, a debtor country may adopt the scheme of blocking the accounts of its creditors. In 1931, Germany, for instance, had done so in order to have exchange restrictions.

Blocked accounts refer to bank deposits, securities and other assets held by foreigners in a country which denies them conversion of these into their home currency. Blocked accounts, thus, cannot be converted into the creditor country's currency. Under the blocked accounts scheme, all those who have to make payments to any foreign country will have to make them not to the foreign creditor directly but to the central bank of the country which will keep the amount in the name of the foreign creditor. This amount will not be available to the foreigners in their own currency, but can be used by them for purchase in the controlling country.

Blocked accounts system has two drawbacks: (i) It reduces international trade to a minimum, and (ii) it leads to black-marketing in foreign exchange.

Multiple Exchange Rates:

In the early thirties, Germany had initiated the device of multiple rates, as a weapon to improve her balance of payments position. Under this system, different exchange rates are set for different classes and categories of exports and imports. Generally a low rate, i.e., low prices of foreign money in terms of domestic currency, is confined to imports of necessary items having an inelastic demand, while a high penalty rate is fixed for the imports of luxury items. In short, the multiple exchange rates system implies official price discriminatory policy in foreign exchange transactions.

Thus, the main merit of the system of multiple exchange rates is that it allows more effective control of the balance of payments. Secondly, it also contains disguised subsidies and tariffs, which may encourage or discourage trade in certain goods and affect the level of foreign trade.

Apparently, buying foreign exchange at a rate above the equilibrium rate amounts to subsidisation of exports, while selling foreign exchange at a rate above the equilibrium rate amounts to a tariff on imports.

Another merit of the system is that it enables the government to yield revenue by buying foreign exchange at low prices in domestic money from exporters and then selling it at higher prices to importers.

However, the system has the following drawbacks:

(i) Instead of correcting the balance of payments, it adversely affects the growth of international trade and the maximisation of world output and welfare.

(ii) It puts too much arbitrary powers into the hands of the government to influence foreign trade.

(iii) It creates undue complexities in calculation, due to different exchange rates for different imports and exports which may be changed from time to time, resulting in uncertainty in foreign trade.

(iv) The system has a formidable administrative problem of effective control. Utmost vigilance has to be maintained against the undervaluation of export invoices and overvaluation of import invoices and care should be taken to see that exporters do not sell their proceeds of foreign exchange in the black-market and importers do make specific and proper use of the allotted foreign exchange. Further, the system is also likely to breed corruption.

We may thus, conclude with Ellsworth that exchange control by the system of multiple exchange rates is only a partial solution to devaluation, and introduces uncertainties and distortions of its own.

Exchange Clearing Agreements:

European countries had adopted this form of exchange control in the Thirties. It was a system for the direct bilateral bartering of goods on a national scale. Under this device, two countries engaged in trade pay to their respective central banks the amounts payable to their respective foreign creditors.

These central banks then use the money in offsetting the corresponding claims after fixing the value of the currencies by mutual agreement. And, importers have to deposit their payment with the central bank can use such money to pay the domestic exporters.

This economises exchange needs for trade. Therefore, exchange clearing device is helpful to a country which has little or no foreign exchange reserves and which is more interested in selling than buying. However, this system is essentially one of offsetting each other's payments, and the basic assumption is that countries entering into such an agreement should try to equalise their imports and exports so that, there will be no necessity for either making or receiving payments from the other countries.

Following are the drawbacks of exchange clearing agreements:

(i) There is a possibility of exploitation of an economically weaker country by a stronger country.

(ii) The exchange clearing agreements involve bilateral transactions in foreign trade, which cause a diversion of normal trade pattern and endanger the promotion of world trade.

(iii) This device also reduces the volume of international trade. Besides, it attempts to do away with the foreign exchange market.

(iv) The scheme requires that all payments have to be centralised.

Payment Agreements:

To overcome the difficulties of the problems of waiting and centralisation of payments observed in clearing agreements, the device is formed as payment agreements. Under this scheme, a creditor is paid as soon as informants.

Under this scheme, a creditor is paid as soon as information is received by the central bank of the debtor country from the creditor country's central bank that its debtor has discharged his obligation and vice versa. By designing the arrangement for mutual credit facilities, thus, possibilities of delay are ruled out. Payment Agreements have the advantage that direct relation between exporters and importers are maintained.

However, payment agreements suffer from two defects:

(i) The agreement accounts could only be debited or credited for licensed payments.

(ii) The balances in the accounts could only be used for payment from one partner to another.

Gold Policy:

Through a suitable gold policy, the country can bring the desired exchange control. For this, the country may resort to the manipulation of the buying and selling prices of gold which affect the exchange rate of the country's currency. In 1936, for instance, the U.K., France and U.S.A. signed the Tripartite Agreement in this regard for fixing a suitable purchase and sale price of gold.

Indirect Methods of Exchange Control:

Apart from the direct methods, there are several indirect methods also regulating the rates of exchange. Important ones are briefly discussed below.

Changes in Interest Rates:

Changes in interest rate tend to influence indirectly the foreign exchange rate. A rise in the interest rate of a country attracts liquid capital and banking funds of foreigners. It will tend to keep their funds in their own country. All this tends to increase the demand for local currency and consequently the exchange rate move in its favour. It goes without saying that, a lowering of the rate of interest will have the opposite effect.

Tariffs Duties and Import Quotas:

The most important indirect method is the use of tariffs and import quotas and other such quantitative restrictions on the volume of foreign trade. Import duty reduces imports and with it rise the value of home currency relative to foreign currency. Similarly, export duty restricts exports; as a result, the value of home currency falls relative to foreign currencies. In short, when import duties and quotas are imposed, the rate of exchange tends to go up in favour of the controlling country.

Export Bounties:

Export bounties of subsidies increase exports. As such the external value of the currency of the subsidy-giving country rises.

It should be noted that import duties and export bounties are treated as indirect instruments of exchange control only if they are imposed with the object of conserving the foreign exchange. Otherwise, the fundamental aim of import duty is merely to check imports and that of export bounty is to encourage exports.

In fine, interest rates, import duty or export subsidy, each has its limitations. For instance, import duty cannot go so far as to completely restrict imports. There is also the fear of retaliation in regard to tariff policy. Similarly, the volume of subsidy depends upon the support of public fund. Likewise, manipulation of exchange rate through changes in interest rate may not be always effective. Moreover, rates of interest cannot be raised to any limit without engendering depression.

Concluding Remarks:

There are various forms in which the exchange control system may be devised. Each form has its own merits and demerits and each one serves a specific purpose. Therefore, the whole economic situation of foreign trade of a country must be carefully viewed while resorting to exchange control and more than one method must be combined together.

In so far as the correction of disequilibirum is concerned, it should be noted that exchange control does not basically solve the problem, it only prevents the situation from becoming worse.

Moreover, exchange control is always an inhibiting factor to an expanding world trade. With its adoption the gains from international trade are reduced and channels of trade are distorted. It also checks the flow of international investments which are very essential for the planned development of world's economic resources. In normal peace times, therefore, it has hardly anything to commend. That is why, International Monetary Fund also has mentioned the removal of exchange controls as one of its major objectives.

Credit Creation :

The Process of Credit Creation in Commercial Banks.

Let us explain the actual process of credit creation. Banks to create credit depends on the fact that banks need only a small percentage of cash to deposits. If banks kept 100 per cent cash against deposits, there would be no credit creation. Modern banks do not keep 100 percent cash reserves.

They are legally required to keep a fixed percentage of their deposits in cash, say 10, 15 or 20 per cent. They lend and/or invest the remaining amount.

which is called excess reserves. A bank can lend equal to its excess reserves. But the entire banking system can lend and create credit (or deposits) up to a multiple of its original excess reserves. The deposit multiplier depends upon the required reserve which is the basis of credit creation. Symbolically, the required reserve ratio:

RRr = RR/D

or RR = RRr x D

Where RR are the required cash reserves with banks, RRr is the required reserve ratio and D is the demand deposits of banks. To show that D depends on RR and RRr, divide both sides of the above equation by

RRr:

RR/RRr = RRr x D/RRe

Or RR/RRr = D

Or 1/RRr = D/RR

Or D = 1/RRr = x RR

Where 1/RRr,

the reciprocal of the percentage reserve ratio, is called the deposit (or credit) expansion; the limits of the deposit expansion of a bank. The maximum amount of demand deposits which the banking system can support with any given amount of RR is by applying the multiplier to RR. Taking the initial change in the volume of deposits (DD) and in cash reserves (DRR), it follows from any given percentage of RRr that

$\Delta D = RR \times 1/RRr$

To understand it, suppose the RRr for the banks is fixed at 10 per cent and the initial change in cash reserves is Rs 1000. By applying the above formula, the maximum increase in demand deposits will be

$\Delta D = 1000 \times 1/0.10 =$ Rs. 10000.

This is the extent to which the banking system can create credit. The above equation can also be expressed as follows:

DD = RR [1+(1-RRr) + (Y-RRr)2+…+(1-RRr)n]

The sum of the geometric progression within brackets gives:

$1/1-(1 – RRr) = 1/RRr$

$\Delta D = \Delta RR \times 1/RRr$

The deposit expansion multiplier rests on the assumptions that banks lend out all their excess reserves and RRr remains constant.

To explain the process of credit creation, we make the following assumptions:

1. There are many banks, say A, B, C, etc., in the banking system.

2. Each bank has to keep 10 percent of its deposits in reserves. In other word 10 per cent is the required ratio fixed by law.

3. The first bank has Rs. 1000 as deposits.

4. The loan amount drawn by the customer of one bank is deposited in full in the second bank, and that of the second bank into the third bank, and so on.

5. Each bank starts with the initial deposit which is deposited by the debtor of the other bank.

Given these assumptions suppose that Bank A receives cash deposits of Rs. 1000 to begin with. This is the cash in hand with the bank which is its asset and this amount is also the liability of the bank by way of deposits it holds. Given the reserve ratio of 10 per cent, the bank keeps Rs. 100 in reserves and lends Rs 900 to one of its customers who, in turn, give a cheque to some person from whom he borrows or buys something. The net changes in Bank A' is balance sheet are +Rs 100 in reserves and +Rs 900 in loans on the assets side and Rs 1000 in demand deposits on the liabilities side as shown in Table 73.1. Before these changes Bank A had zero excess reserves.

This loan of Rs. 900 is deposited by the customer in Bank B whose balance sheet is shown in Table 73.2. Bank B starts with a deposit of Rs. 900, Keeps 10 per cent of it or Rs. 90 as cash in reserve. Bank B has Rs 810 as excess reserves which it lends thereby creating new deposits.

This loan of Rs. 810 is deposited by the customer of Bank B into Bank C. The balance sheet of Bank C is shown in Table 73.3. Bank C keeps Rs 81 or 10 per cent of Rs 810 in cash reserves and lends Rs. 729.

This Process goes on to other banks. Each bank in the sequence gets excess reserves, lends and creates new demand deposits equal to 90% of the preceding banks. In this way, new deposits are created to the tune of Rs. 10000 in the banking system, as shown in Table 73.4.

The multiple credit creation shown in the last column of the above Table can also be worked out algebraically as:

Rs 1000[1+(9/10)+(9/10)2+(9/10)3+…+(9/10)"]

=Rs 1000(1/1-9/10) = Rs 1000(1/1/10) = Rs 1000×10 = Rs 10000.

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