Money Banking Finance Notes, B.Com Part-1

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MONEY PORTION

Q # 1: What is Barter System? Discuss its difficulties/defects/inconvenience? OR How money has reduced the difficulties/defects/inconvenience?

The direct exchange of one commodity or service for another without use of money is called barter system. So a barter system is that in which no money exists. It is money less economy.

According to G. Nomas:
"Barter system is a form of trading in which goods are exchanged directly for other goods without the use of money as an intermediary".

Inconvenience or difficulties of barter system

Double co-incident of wants:

The barter system needs the matching of wants. The exchange of goods is possible if the wants of two parties coincide. For example a person having a table wants to exchange it with the chair. He has to find another person who wants to exchange his chair with table. It is the biggest problem of the barter system. Due to this problem trade under barter system was very limited.

Economic measurements:
Under barter system it was not possible to measure economic variables both at macro & micro level. There was no system to measure personal income or micro level and GDP on macro level.

Future payments:
Under barter system it is very difficult to lend goods to other people. With the passage of time the value of goods may fall. So it becomes difficult to make payments in future.

Estimation and budgeting problem:
Under barter system it is very difficult to estimate expenses and income. The people & the government cannot make any estimate of their income & revenue because it is not possible to forecast the value of goods with any reasonable certainty.
Comparison of living standards:

Living standard of people is a measuring rod of the economic growth of nay country. It is not possible to compare the living standards of people under barter system because there is no unit to express the wealth of people.

Common measure of value:
The barter system has no common measure of value. There is no medium to measure the value of goods. For example a man has a cow and the other has goats and both are willing to trade. The owner of cow estimates the value of one cow equal to the five

goats. But the owner of goats estimates the value of one cow equals to four goats. The exchange cannot take place unless both of them estimate the same value.

Tax collection:

The taxes are collected for the economic development. The amount collected is spent on education, hospitals, roads etc. when tax is collected in the form of goods it is very difficult for the government to spend such goods for development projects. Another problem is that the amount of storage and collection charges may be more than the amount of the tax collected.

Transfer of wealth:

The barter system does not help to transfer wealth from one place to another. The movable and immoveable wealth cannot be shifted from one place to another because sometimes the carriage cost is much higher than the actual cost of wealth. The movement of land and building is not possible at all.

Storing of wealth:

The barter system does not provide the facilities of storage of wealth for longer time period. Some commodities are perishable in nature like vegetable, fruits etc. these goods lose their whole value if stored for longer time period. While other goods like wheat lose their quantity and quality if stored for longer time period. Another problem is that the storing of goods also increases the storing cost.

Sub division:

Many goods are not divisible. Sometimes this fact becomes a very big problem in exchange. For example if a person has a horse and wants to get a pen. The value of the horse is much more than a pen. In this case the exchange is not possible because the horse can not be divided into smaller pieces.

Specialization problem:

Under barter system each person is jack of all trades and master of none. A high degree of specialization cannot be achieved under barter system because everyone tries to attain self-sufficiency.

HOW THE USE OF MONEY HAS REDUCED THE PROBLEM OF BARTER SYSTEM

Revenue collection:

The use of money removed the problem of tax collection. When tax is collected in the form of money only then the government can use it for the development projects.

Ease of borrowing and lending:

The money has removed the inconvenience of future payments. Now the loans can be taken from banks and financial institutions. The future payments can be stated in terms of money.

Medium of exchange:

The use of money eliminated the problems of double coincidence of wants. Now anyone can buy anything and sell anything for money. There is no need to find a person who is need of a thing which you have in surplus. In modern economy people sell their goods and services for money and use that money for purchase of other people.

Measurement of efficiency:
Under barter system there was no standard of measuring efficiency. The use of money has made it possible to measure output, costs and efficiency in term of definite units of money.

Investment and saving:
Money has made it possible and extremely easy to invest and save. Now we can save our wealth by investing it in different saving schemes. Further we can save our wealth in form of foreign exchange, gold, silver etc which can easily be converted into cash when required.

Development process:
In a barter economy the process of development I slow. With the use of money technology has developed, research work has increased: trade has expanded which results in overall economic development.

Increase in foreign investment:
Money has made possible the huge investment in today's world. Under barter system the foreign investment was impossible but the use of money made it possible because in money economy wealth can easily be transferred from one place to another.

Ease of specialization:
In barter system specialization is not possible because everyone tries for self-sufficiency. Specialization not only helps in reducing cost of production but also results in higher production. The increase in production then can be traded to buy other goods.

Storing of wealth:
The problem of storing wealth has been removed by the use of money because wealth can easily be stored in the form of money.

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Q#2: Define money and discuss its functions:

According to Ely:
Anything that passes freely from hand to hand as a medium of exchange and is generally received in final discharge of debts.

According to R.P.Kent:
Money is anything which is commonly used and generally accepted as a medium of exchange or as a standard of value.

Functions of Money

The functions of money can be divided into three main categories:

a) Primary functions
b) Secondary functions
c) Contingent functions

Primary functions

Medium of exchange:

Money has served as a medium of exchange. It is used to make payments for goods and services. Different goods can be sold in terms of money and this money can be used to purchase other goods. So it acts as a medium of exchange between the buyers and the sellers.

Standard of value:

Money is used to measure the value of everything in the same way as we can measure weight in kg and distance in km. it acts as a standard of value. Goods and services are priced and valued in terms of money.

Secondary functions

Monetary and fiscal management:

Money is a very important factor of monetary and fiscal policies. Collection of taxes and public finance management is only possible in term of money. Under barter system it is impossible to collect taxes in form of goods and then to use the amount of tax for developmental projects.

Income and consumption:

Income and consumption of different factors of production is determined in terms of money. Money helps in determination, valuation and budgeting of expenses and revenues.

Specialization

In barter system specialization is not possible because everyone tries for self-sufficiency. Specialization not only helps in reducing cost of production but also results in higher production. The increase in production then can be traded to buy other goods.

Deferred payments/future payments:

The money has removed the inconvenience of future payments. Now the loans can be taken from banks and financial institutions. The future payments can be stated in terms of money.

Economic activities:

All kinds of economics activities such as investments, savings, credit, advances etc are made in term of money. The use of money has facilitated the expansion of trade.

Parameter of market structure:

The use of the money provides basis of market mechanism. The demand and supply are the two major forces of market which works only because of money. Money is the factor which leads to the determination of prices, demand and supply.

Promote foreign trade:
Money has made possible the huge foreign investment in today's world. Under barter system the foreign investment was impossible but the use of money made it possible because in money economy wealth can easily be transferred from one place to another.

Transfer of wealth:
Money also serves as a mean of transferring value from place to place. A person may sell his moveable and immoveable property for money at one place and can use that money to purchase property at some other place.

Contingent functions

Distribution of national income:
With the help of money it is impossible to determine and distribute national income among various classes of society.

Basis on credit system:
Money also provides the basis of bank credit. Banks create credit only when they possess cash. Also the money value of securities is considered by banks while granting loans. Different negotiable instruments also work on the basis of money.

Equalizer of marginal utilities and productivities:
Money enables consumers to get maximum satisfaction through the law of equal marginal utilities. Similarly the producer can get maximum profit by equalizing the marginal productivities of different factors of production.

Liquidity of wealth:
Being store of value and generalized purchasing power money enable people to keep their wealth in most liquid form and to purchase different goods and services for it.

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Q#3: What are the forms/types/kinds of money?

Following are the main forms of money.

1. metallic money
2. paper money
3. bank money
4. legal money
5. plastic money
6. near money

Metallic money:

The money made of any metal such as gold, silver etc is called metallic money. It exists in the form of coins. In our country the coins of Rs. 1, 2 and 5 are the current examples of metallic money. Due to its weight, it is difficult to use this money in large quantity.

Therefore coins are used in small amounts only the metallic money has the following two types:

- Full bodied coins
- Token money

Full bodied coins:

When the face value of the coin is equal to the value of metal contained in the coin, the coin is called a full bodied coin. The gold and silver coins of old times are examples of full bodied coins.

Token money:

When the face value of a coin is greater than the value of the metal it contains, it is called token money. In our country, all the coins are token money.

Paper money:

Paper money refers to notes of different value made of paper which issued by the central bank or government of the country. The paper money can be classified into following types:

- Representative money.
- Convertible money
- Inconvertible money/fiat money.

Representative money:

Representative money is that money which is fully backed by equal metallic reserve. The holder of a bank note can easily get it converted into metallic (gold & silver) form on demand

Convertible money:

It is the form of money which can be converted into gold, silver i.e. metallic reserves. But all these notes issued by the government are not fully backed by gold. The amount of gold kept by the government is a particular proportion of the notes issued.

Inconvertible/Fiat money:

Inconvertible or fiat money is one that we have in our pocket and use in daily business. The face value of such money is more than the value of the paper. e.g. the value of the paper of 100 rupee note is almost nil but its purchasing power is equal to Rs.100. it has this value because it has been declared as legal money by the government, so it is generally accepted as a medium of exchange.

Bank money

This is the most modern form of money this money is also called credit. It only consists of cheques, bill of exchange and drafts.

Cheques:

A cheque is an unconditional order by the client on his bank to pay a certain sum of money to him or to any other party.

Bills of exchange:
A bill of exchange is an order by the drawer to the drawee to pay a sum of money to the drawer or to any other party.

Draft
Draft is a cheque drawn by a bank on its own branch or the branches of another bank requesting it to pay on demand a specific amount to a person named on it.

Legal tender money

The money that a person accepts as a means of payment and in discharge of debt is called legal tender notice. All the notes and coins issued by the govt. and the central bank are legal tender money. Legal tender money is of two types:

Limited legal tender money:
The money which can be used a means of payment up to a certain limit is called limited tender money e.g. coins.

Un-limited legal tender money:
The money that can be used a mean of payment up to any limit or amount e.g all the notes issued by SBP.

Non legal Tender Money

Bank money is the form of cheques, bills of exchange, a promissory notes is not legal tender money. Robertson says it "optional money". So non legal tender money is money which a person may or may not accept as a mean of payment.

Plastic money:
Plastic money means the credit cards, smart cards. Plastic cards which have specially printed set of characters. Recently the use of this money has increase.

Near money:
A type of money which can easily be converted into money. It included deposits, government bonds, printed bonds etc.

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Q#4: What are the qualities of good money?

A good money material must possess following qualities.

General Acceptability:
A good money material is one that I generally acceptable by all without any hesitation. It means that any one will be willing to accept it as a mean of payment and in the discharge of any obligation.

Recognizable:

Good money is one that can be easily recognized by seeing and touching. It should be of such a nature that can easily be identified everyone. Further different coins and notes should be of different color and size in order to avoid of any confusion.

Economical:
A good money material should be economical. The cost of printing currency notes a minting of coins must be low. The material of money must be easily available at reasonable prices.

Elasticity:

The good money material has the quality of elasticity. The material being used must be of such a nature that it can be used to increase the supply of money when there is increase in demand.

Easily Meltable:

The money material should be capable of being melted, re melted can be given suitable shapes and can be stamped. Metals are good money material as these can be given any shape. Paper money can also be recycled to produce new notes.

Portable:

Good money material must be of such a nature that it can easily be transported from one place to another. The paper money can easily be transported from one place to another as compared to coins.

Homogenous:
The material used as money must be of same quality: otherwise it will lack general acceptability. The color, size and weight of the currency notes are kept same so that everyone accepts it in confidence.

Durable:
A good money material should be durable i.e it should not lose value within a short time period. Metals are more durable as compared to any other material that is used as money.

Divisibility:
A good money material must be divisible into small parts without losing its value. Both the costly and cheaper thing can be purchased from such money.

Difficult to copy:
A good money is one which is very difficult to copy. There must be certain mark on it which can be easily identified by everyone.

Stability of value:
The good money material should be comparatively stable in value. If the value of material used in money keep on changing it will create problem for making future payments.

Storability:

One of the qualities of a good money material is that it can be stored for a longer time period without losing value to meet the future needs.

Scarcity:
A good money material should be scarce in quantity or the supply of money issued must kept low as compared to the desire for it. Scarcity of money will keep people always working hard to earn more money in order to meet requirements of life.

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Q#5: Define paper money? What are the merits and demerits of paper money/currency?

Paper money is the most advanced form of money. It fulfils almost all the qualities of good money, as it is economical, easily recognizable, portable and storable. Paper money can be classified into representative, convertible and fiat money. Now a days almost majority of paper currency is fiat money. Different authors have defined paper money in the following words.

In words of Hanson:
Paper money means the paper instruments such as bank notes, cheques, bills of exchange and other forms that take the place of money and act as currency or circulating medium.

In words of F. Perry:
Paper money is documents representing money, such as bank note, promissory notes, bills of exchange or postal orders.

In words of M. Greener:
Paper money means documents with a value stated on them but having no value in them.

Merits of paper money

Cheap and economical:
Normally paper money is much easier to issue. Practically it cost nothing to government. Printing of paper currency is requires certain special types of paper, ink, and printing technology. These things no doubt are costly but overall printing cost is quite low.

Convenience:
Paper money is convenient to transfer and carry. It can be easily kept in pocket. Further it can also be readily converted into cheques, drafts, etc.

Copying:
The design of paper money is very difficult to copy. Further special type of paper and ink is used in paper money that makes it quite impossible to copy. Even if it copied by some fake means then it can be checked by electronic machines.

Homogeneous (Uniform quality):
The paper money has another advantage that it has uniform quality and the holder does not bother for possession of new or old money.

Elastic supply:
Paper money due to its elasticity is very useful for government. Supply of money can be increased or decreased according to the needs of the economy. For example at a peak level of business activity the demand of money increases and the monetary authorities can easily issue paper money to fulfill the demand of money.

Advantage of unlimited legal tender:
Paper money is unlimited tender i.e. any amount of payment or of debt can be paid in it. It can be used to discharge all kinds of business obligations.

Precious metals saving:
Use of paper money results the saving of precious metals of the country. The metals can be used for other useful purposes.

Ease of counting:
Paper money is much easier to count than metallic money. The counting of large amounts in metal form is inconvenient and difficult. On the other hand counting of paper money is easy, convenient and requires little time.

Recognizable
The paper money is easily recognizable. There is no inconvenience of testing the exactness of the money material.

Useful in emergency:
The paper money can be used in emergency life war and floods. The government can meet the expenses by printing notes in shorter time. But metallic money takes long time period for mining, refining and minting the metals.

Stable in value.
The metallic money depreciates due to wear and tear. The paper money helps to control such loss. The depreciation means decrease in the value of coins due to usage.

Easily portable:
Paper money is portable i.e. it can easily be transferred from one place to another as compared to metallic money. The cost of transferring paper money is quite low and it can be transferred in a very short time period.

Demerits of paper money

Demonetization:
The demerit of paper money is that the holder may have to suffer loss. The paper money is fiat money. It is issued by fiat (order) of the government. In case the government cancels the currency notes the holder has to bear full loss.

Exchange rate instability:

The value of paper money is instable and is subject to fluctuations in the exchange rates. The fluctuations in the exchange rate market also produce serious effects on the price level in the economy.

Monetary mismanagement:
Purchasing power of paper money is an ever – changing process. This means that its face value remains same but its purchasing power may decline due to monetary mismanagement.

Excess issuance:
The printing of paper money is quite easy, so in times of need the government can issue notes more than the requirement. As a result supply of money increases that causes inflation in the economy.

Restricted acceptability (limited acceptance):
One of the demerits of paper money is that it has limited acceptance. Its acceptance is limited within the boundaries of a country. It cannot be used to make payments to other countries.

Inconvenience of small denominators:
Paper issue is not for small monetary denominators such as 1,10,25,50 paisa and even for Rs. 1, 2 and 5. In this case metallic money gets preference over paper money.

Troubling Balance of Payments:
Over issue of money results in decrease of value of money and also causes inflation. Due to which price of imported goods increases because they are to be paid by exchanging devalued currency for foreign currency. It results in unfavorable balance of payment.

Short life:
Although the paper currency is not affected by wear and tear but it can be damaged due to fire or water. Due to this the life of the paper currency is much less than the metallic money.

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Q#6: Define inflation. Discuss its types/kinds:

Inflation is a process in which the price level is rising and the money is losing its value. Inflation occurs when quantity of money in circulation increases beyond the requirements. Inflation has been defined in different ways by different economists; some of the definitions are as under:

Definitions:

According to R.P.Kent:
"Inflation is nothing more than a sharp upward movement in the price level".

According to Coulborn:

"Inflation means too much money chasing too few goods".

According to Pigue:
"Inflation exists when money income is expanding more than in proportion to income earning activities"

Types of Inflation

Inflation can be categorized on the following basis.

On the basis of rate of inflation:
Following are the types of inflation on the bases of rate of inflation.

1. creeping inflation
2. walking inflation
3. running inflation
4. galloping inflation

Creeping inflation:

When the increase in the price level is not more than 2% per annum, the inflation is called creeping inflation.

Walking inflation:
In walking inflation, the price level increases more rapidly than in creeping inflation. It may go to 5% p.a.

Running inflation:
A general rise in price level up to 8% to 10% p.a. is called running inflation.

Galloping or hyperinflation:
In a situation where price level rises very rapidly within a short period of time, the inflation is called galloping inflation.

On the basis of degree of control

Inflation is classified into the following categories on the basis of degree of control:

1. open inflation
2. suppressed inflation

Open inflation:
The situation when inflation gets out of control and cannot be suppressed by the government price control or any other similar steps.

Suppressed inflation:
The situation when government is in a position to control inflation by its price control policy.

On the basis of Causes

Inflation can be divided into categories on the basis of its causes.

1. demand pull inflation
2. cost push inflation

3. budgetary inflation
4. monetary inflation
5. wage spiral inflation
6. imported inflation
7. devaluation inflation

Demand pull inflation:
When demand for goods and services is more than their supply, the price level of these goods and services will rise causing demand pull inflation.

Cost push inflation:
When the cost of production or the remuneration of factors of production increases, there will be an increase in prices causing cost push inflation.

Profit induced inflation:
Sometimes the businessmen increase the prices of their products only to increase their profit margin. It causes profit induced inflation.

Budgetary inflation:
When the government covers the budget deficit by borrowing money, budgetary inflation will be caused.

Wage spiral inflation:
Workers often demand increase in wages. If wages are increases, the cost of production will rise and prices of the products will go up. This inflation is called wage spiral inflation.

Imported inflation:
Imported inflation is caused by the increase in the prices of the imported goods which are used as raw material in domestic production.

Devaluation inflation:
Devaluation makes the domestic currency cheaper in terms of foreign currencies. It results in the increased prices. The inflation thus caused is known as devaluation inflation.

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Q#7: Define inflation. Discuss the causes of inflation:

Causes of inflation

There are following types of Inflation

i. Demand pull inflation
ii. Cost push inflation

Demand pulls inflation:
Demand pulls inflation occurs when there is a general increase in price level due to increase in aggregate demand for goods.

Cost pushes inflation:
Cost push inflation occurs where there is an increase in the prices due to increase in cost of production.

Causes of demand pull inflation

Following are the causes of demand pull inflation.

Deficit financing:
Sometimes government may prepare deficit budget to complete its various projects. The govt. takes loans from various sources to spend on roads, bridges etc. As a result of such projects the income of the people increases but there is no increase in the output of the goods.

Decrease in production:
In under-developed countries, the population growth causes low output of goods and services. These factors keep production and output low and cause a rise in prices.

Expansion of currency:
When govt. issues currency more than the requirements of the trade in economy, the circulation of currency increases causing inflation.

Expansion in credit:
The credit expansion also creates inflation. When commercial banks issue loans to the private and public sector it results in increase in money supply which increases demand for goods and as a result price level increases.

Evils of society:
Black marketing earned by people through evils like smuggling, hoarding, black marketing causes inflation.

Foreign remittances:
Foreign remittances increase the supply of money of the receiving country without increasing production which results in inflation.

Increase in wages:
With the increase in wages, the purchasing power of the people increases which result increase in demand and prices go up.

Consumption habits:
Many people of poor countries have consumption habit of rich countries. This trend gives rise to demand and caused inflation.

Increase in investment:

Investment gives rise to wages, cost of production and savings. All these factors bring more money and create inflation.

Tendency of increasing population:

Increase in population causes increase in demand when demand goes up the price rise.

Causes of cost push inflation

Following are the causes of cost push inflation

- Increase in wages
- Rise in price of imported goods
- Increase in taxes
- Devaluation
- Increase in the prices of inputs.

Increase in wages:
An increase in wages of individuals increases the income and on the other hand it causes an increase in the cost of production. This increase results in rise in prices.

Rise in the price of imported goods:
When the prices of the imported raw material used in local manufacturing increases, the cost of manufacturing goods goes up. This cause inflation.

Increase in taxes:
The taxes that the Govt. imposes on manufacturers increase the cost of production, this again result in the rise in prices.

Devaluation:
Devaluation of currency decreases the purchasing power of the local currency. The imported goods become dearer that ultimately increase the cost of production.

Increase in price of inputs:
If there is an increase in the price of inputs, raw material, gas, electricity, etc. the cost will go up and result will be increase in inflation.

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Q#8: Define inflation. Discuss remedies to control the inflation?

Remedies/control of inflation

The steps taken to control inflation can be classified into followings:

- Monetary measures
- Fiscal measures
- Other measures

Monetary measures

Supply of money:

The control over money supply is an effective method to control inflation. If there is inflation it can be control by reducing supply of money by using the tools of monetary policy.

Credit control:

Issuance of loans by the banks increases money supply in the country which results in inflation. Central bank by imposing restrictions on the loans can control the supply of money which helps to control the inflation.

Saving habits:

If the government increases interest rate on deposits/saving schemes it will induce people to invest in such schemes. As a result circulation of money reduces which help to control inflation.

Monetary reforms:

In order to control inflation the government can implement monetary reforms. Under this method government can exchange old notes for new notes and large amount of notes can be blocked. Such blocked money can be reissued after the certain time period. Such system was adopted in Poland, Norway and Denmark.

Fiscal measures

Increase in taxes:

The increase in taxation reduces the purchasing power of the people. The money moves from general public to the government. By this supply of money is reduced in the economy which results in controlling prices.

Controlling exports:

By controlling the level of exports the inflation can be controlled. The products which are short in the domestic market should not be exported to other countries. If such products are exported their prices will rise in the local market due to shortage.

Decrease in import duty:

If the duty on imported goods is reduced it will reduce the cost of local sellers and enable them to sell their products in the local market at lower prices.

Other measures

Price control:

It is very effective method to control the prices. In this method the government appoints a price control committee to maintain stable price level in the country. Under this method the sellers are not allowed to sell their products at high prices.

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Q# 9: Define trade cycle. Discuss its phases?

The business activities always keep on changing sometimes there is a period of good trade and sometimes bad. A period of good trade is followed by a period of bad business conditions. These ups and downs don't remain same forever. This wave like fluctuation in the business activities is known as business or trade cycle.

Definitions:

According to Hansen:
"Business cycle is a fluctuation in employment output and prices".

According to Keynes:
A trade cycle is composed of period of good trade characterized by rising prices and low unemployment percentage alternating with periods of bad trade characterized by falling prices and high unemployment percentage"

Phases of trade cycle:

- Boom or prosperity
- Recession
- Depression
- Recovery

Boom or prosperity:

It is a state of overall happiness. It is the best economic situation with rapid increase in overall business activities. Following are the characteristics of this phase:

Characteristics:

Increase in investment:
In this stage the investors are investing all of their resources as it is a time period of prosperity and there are chances to earn maximum profit.

Increase in prices:
During this stage overall price level increases & as a result the profit of businessmen increases.

Increase in production:
Due to increase in investment production level increases rapidly during this stage.

Increase in employment:
Due to increase in investment & increase in production there are more opportunities for people to get employed. Due to this factor overall employment level increases.

Increase in income:

During this stage the income level of people increases. People have high purchasing power which results in more demand for goods.

Recession:

This phase starts after the phase of boom. During this stage the business activities starts declining i-e. Slowdown of business activities.

Characteristics:

Decreasing prices:
During this stage the general price level starts to decline as a result the profit of businessmen also decreases.

Decreasing investment:
As a result of decreased profits of the business class the investment level also decreases. Investors stop making new investment due to decrease in the price.

Decreasing production:
As a result of decreasing in investment the production level also decreases.

Decreasing employment:
Due to decrease in investment job opportunities also decreases which reduces employment level.

Decreasing income:

As there is a decrease in production and employment the income of the people also decreases.

Depression

If the slowdown of general economic activity continue over longer time period and is very severer then it is known as depression phase of the trade cycle.

Characteristics:

Low level of investment:
During this stage investors stop investing and overall investment level reaches to its minimum.

Low level of prices:
In this phase there is a fall in the general price level which results in decreased profits of the business class.

Low level of production:
During this stage most of the firms reduces their production because of very low profit.

Low level of employment:

During this stage employment level also decrease due to fall in investment and production.

Low level of income:
During this phase the employment level is very low which reduces the income level of people.

Recovery

Characteristics:

Improvement in investment:
In this phase economy starts improving and investors start to invest in the economy which increases overall investment level.

Improvement in price:
In this stage the general price level also improves and businessmen starts making profit.

Improvement in production:
Due to increase in price level the profit of the sellers increase and as a result they increase their production.

Improvement in employment:
In this stage employment level starts improving due to increase in investment and improved economic condition.

Improvement in income:
Because of increased employment and high price income level also increase.

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Q#10: Define foreign exchange. How rate of exchange is determined. What are the factors that affecting rate of exchange. Also explain type of exchange rate.

In general the term foreign exchange means the currency of other countries, a system of international payments or the rate at which banks buy and sell foreign currency. Different authors have defined it in the following words.

Prof Hartley:-
Foreign exchange is a mechanism by which international indebtedness is settled between two countries.

H.E.E. Vitt:
The mean and method by which right of wealth expressed in terms of currency of one country are converted into nights to wealth in terms of the currency of another country area known as foreign exchange.

Determination of rate of exchange by demand and supply theory

The rate of exchange can be determined from the forces of demand and supply like the price of a commodity. The rate of exchange between two currencies is at equilibrium if the supply and demand of the currency becomes equal. If the demand for foreign exchange increases the rate of exchange increases & similarly if demand for foreign exchange decreases then rate of exchange falls

Demand for foreign exchange

The demand for foreign exchange arises due to.

Imports:

When the import of goods increases the demand of foreign exchange also increases and due to which the value of home currency decreases.

Tourists:

The demand of foreign currency also increases when tourists of a country go abroad due to this the value of home currency reduce.

Foreign education:

When students of a country go abroad for higher education then demand of foreign currency also increases due to which the value of money decreases.

Remittances by foreignness to their native countries:

Remittances by foreigners or foreign companies working in Pakistan to their native countries increases the demand of foreign exchange, which reduces the value of home currency.

Payment of foreign loans/ interest:

When a country wants to repay loans and interests the demand for foreign currency increases which reduces the value of home currency.

Business services: Demand for the foreign currency also increases when we have to pay for business services hired from foreigner's e.g, freight, insurance banking services etc.

Payment for health care:

When people go abroad for health care the demand for foreign currency also increases which reduces the value of home currency.

Supply of foreign exchange

The supply of foreign exchange increases due to following:

Exports:

When the exports of a country increases the supply of foreign exchange increases in the country, which increases the value of home currency.

Tourists:
When foreign tourists come to a country they increase the supply of foreign exchange that improves the value of home currency.

Foreign students:
The supply of foreign currency also increases when foreign students come to a country for studies and the value of home currency.

Foreign investment:
When there is an increase in the foreign investment in the country it also increases the supply of foreign exchange due to which value of home currency increases.

Foreign remittances:
People and organization working abroad send remittances to their native country and increases the supply of foreign exchange in the country which increases the value of home currency.

Factors influencing rate of exchange

As the exchange rates are determined through demand and supply forces in the foreign exchange market so any factor that brings change in either demand or supply will immediately influence the exchange market following are the important factors.

Imports:
If imports are greater than exports it results in increasing demand of foreign currency that will depreciate our home currency.

Influence of price level:
If the price level in Pakistan decreased then exports will increase because our goods become cheaper in international market and the value of home currency increases and vice versa.

National income:
When country explore more natural resources it results in less dependence on others. This results in low level of imports and demand for foreign currency decreases and value of home currency increases.

Capital movement:
A country where the capital inflow rate is very high the value of home currency increases but if there is increase in capital out flow then demand for foreign currency increases due to which value of home currency also decreases.

Rate of interest:
The bank rate also influence exchange rate. If the bank rate rises, funds will flow to this country from abroad to earn high interest rate and exchange rate will move in favor of this country and vice versa.

Exports:

If exports of a country are more than its imports then demand for home currency increases and rate of exchange moves in country favor.

Affects of stock exchange:
Working of stock exchange market also influences exchange rates. If there is a healthy business of shares & debentures is going on this will have good effect on exchange rate and value rupee improves. But if business is slow then investments will not flow and value of our currency falls.

Stable political conditions:
If there is political stability in the country then there will be an increase in the capital inflow which increases in the value of home currency and vice versa.

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Q # 11: What are the causes of nationalization of banks? Explain the advantages and disadvantages of such nationalization?

Introduction:
The commercial bank can be opened by private persons or government. A private commercial bank is opened by private persons. The ownership and control remains in their hands. But sometimes the ownership of private banks is taken over by the government. It is called nationalization of commercial banks.

Nationalization of banks:
The government has nationalized all the 23 schedule banks with 2942 branches with deposit of Rs. 1580 crores on 1st January 1974. The main purpose of the nationalization of banks was to increase in government revenue and better utilization of monetary resources of the country. After nationalization they were merged into five banks.

- National bank of Pakistan
- Muslim commercial bank
- United bank limited
- Habib bank limited
- Allied bank limited

Causes of Nationalization

The causes of nationalization of commercial banks are as under:

Concentration of wealth:
The banks mainly lend to big depositors or industrialists. Many small producers were unable to get loan facility. According to one estimate 200 families borrowed 75% of the total loans and advances. A few people were using the national saving in their own interest. The result was concentration of wealth in few hands.

Misuse of loans:

The loans were issued against securities. There was no check to see whether these were used for productive purpose or not. The use of loans was not in the national interest. These loans were used for hoarding black marketing and speculation.

Loan distribution:
The loan distribution policy for various sectors of the economy was not clear cut. The banks were providing loans in their own interest. According to one estimate only 10% of the loans were issued to agriculture. As a result agriculture remained backward

Protection of black money:
Private Banks of the country protected the black money of high officials. Even the government is not allowed to check the balance of such persons.

Wasteful competition:
The banks were busy in wasteful competition. A heavy amount was being spent on advertisement. Perhaps such expenses were more than Rs. 25 million per year.

Banking profits:
The banks were providing loans to maximize the profit at the cost of national interest. The profit earned by the banks was not helpful in the economic development.

Overseas branches:
The performance of overseas branches was poor. The bank officers were going abroad for the inspection and audit of branches. They were allowed to visit foreign countries and all expenses of tour were charged to the concerned branches. Many of such branches working at loss.

Bank employees:
The employment and promotion in banks was due to deposits. The hard labor devotion and intellectual were useless.

Relatives of bankers:
The bank owners provided key posts to their relatives. They were providing heavy salaries and other benefits. They were not professionals.

Ineffective central bank control:
There was ineffective control of the state bank on the schedule banks. They did not follow the policies of the state bank for providing loans.

Advantages of nationalization

Following are the main advantages or effects of nationalization of banks:

Job security:
The job of the banks employees has become secured after nationalization. The other benefits are also allowed to the employees. They receive car advance, house building finance and also entitled to provident fund.

Job opportunity:
The expansion of banking business and opening of new branches has created new job opportunities for many people.

Uniform policy:
All the banks will adopt policy about credit expansion after nationalization. While before nationalization it was not possible.

Use of profit:
Before nationalization all the profit of the bank industry was in few hands but after nationalization it is used for the best interest of the whole nation. So government nationalized them in 1974.

Increase in rural branches:
The nationalized commercial banks have opened branches in rural areas. The rural deposits have increased many times after nationalization.

Control over expenses:
The expenses of nationalized banks have been controlled to a large extent.

Control over credit:
The SBP control over the commercial banks has increased. The credit policy is prepared by the state bank for commercial bank and issues instruction from time to time. Therefore the state bank has got control over credit to some extent.

Banking business:
The government has set up an executive board to look after the administrative work. The business of banking has improved due to the better management.

Service motive:
Before nationalization, there was only profit motive for the banker and service motive was ignored. So it was necessary that banks should be nationalized.

Loans and advances:
The state bank of Pakistan declares the loan policy of these banks. All the banks follow the policy. Therefore the loan is provided to industrial and commercial sectors including small industries.

Protection to depositor:
The deposits of the people are saved due to control of government because government is responsible for the risk of loss to the depositors.

Development of banks:
There is a large development in the field of banking after nationalization on January, 1st 1947 there were 3123 bank branches and on December 31st, 1987 there were 7100 branches.

Disadvantages of Nationalization

1. fall in standard service
2. restriction on recruitment
3. low salaries
4. control of bureaucracy
5. immigration of skilled persons
6. low level of competition

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Q#: 12 Explain different causes and features of privatization of bank in Pakistan. Discuss its different evaluations?

Introduction

In January 1991, the nationalization of bank act, 1974, was amended. As a result government become authorized to transfer the management of commercial banks to private sector.

Causes of privatization:

- The nationalization banks were working under the political pressure.
- There were complaints from the customers regarding.
- Over staffing
- Inefficient counters services
- Delay in dispatch of cheques and drafts
- Delay in home remittance
- The revenues and profits of NCBs
- The quality of services improved by NCBs went on deteriorating

Features of privatization

Management:
The banks would have autonomous status and they will be run commercially.

Decentralization of operation:
To run the banks a board of director will be setup. The board will transfer its power to a management committee. Banking operation will be performed by committee at head office.

Customer services:
In order to improve their efficiency the commercial banks will provide improved services to their customers.

Recruitment:
The appointment of banking staff will be made through competitive examinations to be held under the supervision of Pakistan banking council and PFS (Pakistan financial services).

Evaluation of privatization of banks

A question arises, that what will be the effects of privatization on national economy. These will be positive and negative effects.

Positive effects or their merits:

Following are the positive effects of privatization of banks.

Increase efficiency of banks:
Thus due to the privatization of banks, the efficiency of banking system increase.

Competition among banks:
There will be a healthy competition among banks in respect of services.

Customer services:
Due to competition the banks increase the level of services provided to their customer.

Earn profit:
The burdens on government will decreases when the banks earn greater profit.

Political interference:
The political interference will be eliminated.

Negative effects or demerits:

Unequal distribution of loans:
The pre-nationalization model of banking structure will develop. Again the small businessman and the formers will remain deprived of the bank loans.

Distribution of wealth:
The distribution of wealth will become more uneven. Thus again the problem of concentration of wealth in few hand will arise.

Exploitation of banking staff:
The private banks will leave no chance to exploit their staff and workers. There will be bargaining between the employees and employers. The labors may be deprived of benefits while owners would be earning profits.

Profit making activities:
The private banks will be profits minded, rather development minded. The private banks again involve in the unhealthy competition.

Role of SBP:
The SBP will not be able to implement its monetary policy and credit plan effectively.

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Q # 13: Critically examine quantity theory of money?

Introduction:

This theory was presented by JOHEN BODEN in 1568, but IRVIN FISHER popularized it in 1911 by formulating quantity equation, which again molded to cash balance equation.

Explanation:

The simplest quantity theory can be explained as, when the quantity of money is increased in the society the price level also increased and the value falls. On the other hand when the quantity of money declines the price level is also decline and the value of money increases.

STATEMENT OF THEORY

According to Irving Fisher:

"Other things remaining the unchanged as the quantity of money in circulation increases, the price level also increases in direct proportion and the value of money decrease and vice".

Fisher's Equation:

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

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

Here:

P = Price Level
T = Volume of transaction
M =Quantity of money in circulation
V = Velocity of circulation of money
M'' = Credit Money
V'' = Velocity of Credit money

The equation states that supply of money ($MV + M''V''$) is equal to demand (PT) for it. In this equation money included currency money credit money and their velocity

Suppose:

$M = 100$, $M'' = 200$
$V = 5$ $V'' = 5$
$T = 50$

Then:

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

$$P = \frac{(100)(5) + (200)(5)}{50} = 30$$

When M is double:

$M = 200,\ M'' = 400$

$V = 5\ V'' = 5$

$T = 50$

$$P = \frac{(200)(5) + (400)(5)}{50} = 60$$

When M is double:

$M = 50,\ M'' = 100$

$V = 5\ V'' = 5$

$T = 50$

$$P = \frac{(50)(5) + (100)(5)}{50} = 15$$

Assumptions:

No change in barter trade:

It is assumed that there is no change in barter trade. If barter trade decreases, the use of money increases. But if barter trade increases the use of money decreases.

No Change in Volume of Trade:

It is assumed that volume of trade does not change. Volume of trade depends upon natural resources, population, supply and efficiency of factors of production. So it is assumed that there is no change in population, natural resources, supply and efficiency of factors of production.

No change in credit money:

It is also assumed that credit money such as bill of exchange, cheques in circulation is remained constant. If supply of quantity of money is decreased but credit money is increased then the prices may not be change.

No change in velocity of money:

Velocity of circulation means that one unit of money how many times passes in different hands. For example if a ten rupee note changes hands five times then the quantity of money in this case will be Rs. 50 and not Rs. 10. But according to this theory it has been assumed that velocity of circulation of money remains constant. There is no change in it.

Short periods:

The theory applies to the changes in prices only in short periods.

Full employment:

It is assumed that there is full employment in a country and all factors of production (Land, labour, capital and organization) are fully utilized. No resources are idle.

No change in hidden money:

There should be no change in the quantity of hidden money. If supply of commodities is increased and hidden money also comes in circulation then prices will not be changed.

Criticism:

Circulation of money:
It is very difficult to measure the circulation of money in the country. Therefore velocity cannot be calculated within the country.

Removed the rate of interest:
Another serious defect is that this theory does not take into consideration the influences of the rate of interest of cash balances.

Independent variables:
All the assumptions are interlinked. If one variable is changed the other is also changed. Therefore this in not correct.

Trade cycle:
The theory does not provide a satisfactory explanation of changes in prices during different phases of a trade cycle. The theory tells that prices do not change except, when there is change in quantity of money. But in a period of depression prices fall even when quantity of money remains unchanged.

Changes in population:
Practically the population does not remain same. It increases day by day and also affects the prices.

Ignores long period
This theory ignores the long period of time and just discusses the short period.

Statistic theory:
The quantity theory of money is a statistic theory. This world is dynamic and things are changing at a fast speed. The changing world ups and downs in economy cannot be explained under such theory.

Store of value:
This theory ignores the money hold by the people.

Unemployment:
This theory assumed that there is a full employment but it is not possible in real life.

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BANKING PORTION

Q# 14: Discuss the types/kinds of Banks?

Introduction:

A commercial bank is an organization, which deals in money. It accepts the saving of the people and then these deposits are advanced to other people. In the whole process the bank earns money. Commercial banking is the need of today's economy. In all the economic activities like consumption, exchange, trade, investment, etc. banking is important.

Definition:

A banker is an institution which receives deposits and advances loans.(Kinely)

Definition:

A banker is a dealer in capital or more properly a dealer in money. He is an intermediary party between the borrower and the lender.(Gilbert)

Definition:

A baker collects money from those who have it spare or who are saving it out of their incomes. It lends money to those who require it.(Crowther)

Banks are classified into various types on the basis of their functions, ownership, domicile etc. the main types of banks in Pakistan are:

FUNCTIONAL CLASSIFICATION

Central Bank:

This is the most important bank of the country. All the countries of the world have their own central bank. In our country state Bank of Pakistan is the country's central bank. In England the Bank of England works as central bank.

The central bank is the head, the leader and the supervisor of the banking and monetary system of a country. It controls the flow of money and credit in the country. It is not a profit seeking institution.

Commercial Bank:

These banks are profit seeking institutions. They receive deposits, advance loans and create credit. These banks also perform the agency and utility services for the people. In Pakistan National Bank of Pakistan (NBP), Habib Bank limited (HBL) are performing functions of commercial bank.

Industrial Bank:

Industrial banks provide medium and long term loans to the industry. These banks solve the special financial problems of the industry by providing funds for the purchase of raw material, machinery etc. in Pakistan we have Industrial Development Bank of Pakistan(IDBP), Small and Medium Enterprises Bank(SME) and Pakistan Industrial credit & Investment Corporation(PICIC).

Agricultural Bank:

This bank provides financial assistance to agriculture sector. Bank provides loans for purchase of seeds, fertilizers and agricultural equipment. Agricultural bank provides short term and long term loans to the farmers and land owners at lower rate of interest. Agricultural Development Bank of Pakistan (ADBP).

Investment Bank:

The main functions of these banks are the sales and purchase of shares, bonds and securities. In 1966, Investment Corporation of Pakistan (ICP) was established before this, there was no such institution in Pakistan.

Saving Bank:

These banks collect saving of the people. These banks have been established to promote saving habits among the people of low earning. In Pakistan we have institutions like National Saving Centre (NSC) and Post offices. Commercial Banks also act as saving banks.

Exchange Banks

These are the banks which provide foreign exchange to the importers and exporters of the country. These banks convert local currency into foreign currency and make foreign payments.

Mortgage Banks:

These banks mortgage land, houses and other property and advance loans. Such banks exist in some countries but there is no mortgage bank in Pakistan.

ON THE BASIS OF OWNERSHIP

PUBLIC BANK:

These banks owned and supervised by the government. In Pakistan we have NBP as a public bank.

PRIVATE BANK:

These are private sector banks owned by corporations such as MCB, ABL etc.

COOPERATIVE BANKS:

These banks provide services for the small scale business and provide short and medium term loans. In Pakistan these banks are working under corporate societies Act 1925. e.g. Punjab Cooperative & Federal Cooperative bank.

ON THE BASIS OF DOMICLIE

Domestic bank:

These are the banks that are registered with the country. E.g. NBP, HBL.

Foreign Banks:

These are the banks which are registered in foreign countries. e.g. Standard Chartered Bank, Citi Bank.

Scheduled banks:
The banks which work under the control of Central banks are known as Scheduled Banks. These banks must have paid up capital not less than Rs. 5 million.

Non Scheduled Banks:
The banks which are not working under the supervision of the central bank are known as Non Schedule banks. These banks have minimum paid up capital of Rs. 50,000 but not more than Rs. 5 million. e.g Small Business Finance Corporation.

According to Incorporation

Chartered bank:
These are the banks which are established by the order of the king (royal Order). These banks functions laid down by their charter.

Statutory Bank:
These banks are formed by the order of the head of state or by the special act of parliament. The main object of these banks is the welfare of public and profit is not so important e.g. SBP.

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Q # 15: what is commercial bank? Describe its Major/ Basic/ Primary and Minor/ Secondary/ Ordinary functions in detail.

INTRODUCTION
It is an up hill task to trace the origin of word "bank". Some people think that "banco" is the origin of bank**. "Banco"** means a bench. The early bankers had done their business on the benches "banco" means a bench. The early bankers had done their business on the benches "banco" means a bench. The early bankers had done their business on the benches in Lombardy-Italy. There are others who say that "back" is the origin of it. It is a German word and means a joint stock fund. There is no record for checking the correct opinion.

COMMERCIAL BANK
It is rightly said that "like" many other things a banker is easier to recognize than to define ". The activities of the banks are ever increasing. The definition stated today will be out tomorrow. There is no complete definition which covers all the functions of a commercial bank.

DEFINITIONS:
According to KINELY:
"A banker is an institution which receives deposits and advances loans".

According to GILBERT:

"A banker is a dealer in capital or more properly a dealer in money. He is an intermediary party between the borrower and the lender".

FUNCTIONS OF COMMERCIAL BANK

Primary or basic or major Function (A)

Accepting deposits:

Accepting the deposits is the basic function of banking business. The bank collects money from the public. The lending power of a bank depends upon it. In order to attract.
The public, the bank introduced various types of deposit schemes. The main deposits schemes are as follows:

1. Current Account or demand deposit:
This type of account is suitable for businessmen. The banks normally do not pay interest (profit) on this account. No deduction of zakat is made on this type of account. The depositors can withdraw the money deposited in the current account any time.

2. Savings Account:
These accounts are suitable for middle-income group people. On this account the lower rate interest rate is given. Deduction of zakat is made on this type of account. In the case of deposits, the depositors cannot withdraw his amount beyond a specific limit fixed by the rules of the bank.

3. Fixed Deposit Account or time deposit:
In the case of fixed deposit, depositors place their money in the bank for a specific period i.e. months to years or more. On this account, bank pays higher interest rate. It is also known as "Time liabilities of bank".

(B) Making Loans and Advance or Employment of funds:

Bank also advances loans to business, traders and exporters. Infact banks borrow money in order to lend it at higher rate of interest. This is the major source of banks. The main types of loans guaranteed by the bankers are:

1. Overdraft or Running finance:
In case of overdraft the customer is allowed to draw certain amount of money over and above their deposited amount. The person who has kept his account with bank can ask for overdraft and the bank can grant him overdraft. The interest is charged from the customers on the overdrawn amount.

2. Cash Credit or Cash finance:
Under this system banks also allow the customers to borrow against the security of moveable and immovable assets for short period.

3. Money at Call or call loans:

These are very short period loans. This advance is given to the stock exchange for a very short period.

4. **Discounting of bills of Exchange:**
It is very popular type of lending by the bank. The banker after discounting, pays the value of the bill to the holder.

5. **Personal Loans:**
Banks are now also granting personal loans for the purchase of motor cars, household appliances house repairs etc.

C- Remittance or Transfer of Money

The money can be transferred by bank from one place to another by means of bank demand drafts, (D.D) telegraphic transfers (T.T) mail transfer (M.T) and Pay-order (P.O) etc.

D- Payment of Cheques

The payment of cheques on behalf of his customer is also essential function of a bank. Bank undertakes to pay the proceeds (amount).

MINOR OR SECONDARY OR ORDINARY FUNCTIONS

1. **Services of Hajj**

Banks also provide services of hajj to his customers and public.

2. **Evening Banking**

After regular working hours the banks offer evening banking services. In Pakistan utility bills are collected in the evening. The bank also receives deposits after banking hours.

3. **Collection of Zakat**

The banker collect zakat from various accounts holders on behalf of Government.

4. **Collection of Income**

The bank as an agent collects pension, dividends, rent and interest for the customers.

5. **Acts as Trustee**

If a client direct his bank to act as a trusty in the administration of a business. The bank performs this responsibility.

6. **Dealing in Securities**

The commercial bank purchase and sells the securities for himself and sometimes on the behalf of the customer.

7. **Advice on Financial Matters**
Sometimes the banks give valuable advice on various financial matters to their customers.

8. **Representatives and Attorney**
The banker act as attorney and representative of his customers.

9. **Referee**
Banks act as a referee and provide information relating to the credit worthiness of their customers.

10. **Issuance of Letter of Credit (L.C)**
Banks issue commercial letters of credit for facilitating and financing foreign trade. They also issue letter of credit.

11. **Issuance of Credit Cards**
In the modern age the bank issue credit cards to their customers. These credit cards are acceptable worldwide and thus provide special facility to the customers.

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Q # 16 Discuss the role of commercial banks in economic development?

Introduction:

A commercial bank is an organization, which deals in money. It accepts the saving of the people and then these deposits are advanced to other people. In the whole process the bank earns money. Commercial banking is the need of today's economy. In all the economic activities like consumption, exchange, trade, investment, etc. banking is important.

Definition:
A banker is an institution which receives deposits and advances loans.(Kinely)

Definition:
A banker is a dealer in capital or more properly a dealer in money. He is an intermediary party between the borrower and the lender.(Gilbert)

Definition:
A baker collects money from those who have it spare or who are saving it out of their incomes. It lends money to those who require it. (Crowther)

Role of commercial banks in economic development of Pakistan

The role of commercial bank in the economic development of Pakistan is discussed as follow:

1. **Development of trade:**

The commercial banks collect the savings of the people and provide them for trade activities. Successful businessmen work in cooperation with the bank.

2. **Development of agriculture:**

Commercial banks finance the most important sector of developing economies .i.e. short, medium and long term loans are provided for the purchase of seeds, fertilizers and machinery.

Development of industry:

The countries, which concentrated on industrial sector of made rapid economic development. South Korea Malaysia, Taiwan, Hong Kong and Indonesia have recently developed their industrial sector with the help of commercial banks.

3. **Development of transport:**

The commercial bank financed the transport sector through Prime Minister Transport scheme. It has reduced unemployment on one hand and increased the transport facility on the other hand.

4. **Development of foreign trade:**

Commercial banks help the traders of two different countries to undertake the business. Letter of credit is issued by the importer's bank to the exporter to ensure the payment.

5. **Development of economy:**

A sound banking system promotes the economic status of the people by providing them short term, medium term and long term loans.

6. **Export promotion cell:**

In order to boost the exports of the country, the banks have established export promotion cell. These cells provide information and guidance to the exporters.

7. **Employment opportunities:**

Banks provide investment and in this way they create employment opportunities.

8. **Educational loans:**

In Pakistan commercial banks provide educational loans. These loans are called Qarz-e- hasna. These loans are advanced for a long period of time. Qarz-e-Hasna is for those students who cannot afford their educational expenditures.

9. **Collection of dividends:**

The bank provides very useful services in the collection of dividends on behalf of the customers.

10. **Collection of zakat:**

All commercial banks can collect zakat on behalf of the government, and assists the government in distribution of zakat.

11. **Collection of taxes:**
Commercial banks collect the taxes on behalf of the government.

12. **Custodian of precious articles:**
Banks also provide locker for the safety of precious articles.

13. **Cheap medium of exchange:**
By issuing cheques and drafts bank provides cheap medium of exchange.

14. **Climate for capital formation:**
Capital formation depends upon the level of investment and savings. If the rate of saving is higher, then the rate of capital formation is also higher. Banks can increase the capital formation by stimulating saving and incomes.

15. **Increase in saving:**
Saving is an essential requirement of economic development. Banks collect small saving which becomes a huge amount. Banks launch different saving schemes to attract the people.

16. **Increase or decrease the volume of money:**
The commercial banks play a very important role in the implementation of monetary policy. They work under the supervision of SBP and try to increase or decrease the volume of money according to the needs of the economy.

17. **Islamization:**
Islamic economic system is the best for our economy. Banks provide their full support for the introduction of Islamic banking in Pakistan.

18. **Investment:**
Banks also make an investment in different companies and industries. A developed banking stimulates the growth and capital formation.

19. **Investment advising:**
Banks also provide the services of advisor for making investment in trade and industry. In the absence of banking system, many businessmen cannot get the services of specialist and may bear loss.

20. **Idle funds utilization:**
The idle funds of individuals and firms get utilized through banks. This help in expansion of productive capacity in a country. People deposit their idle funds in banks because banks allow them interest.

Conclusion:
In short a sound banking is essential for economic development. Banking is the part of a country's infrastructure. The most important role of banking is capital mobilization which in fact brings development.

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Q# 17: CENTRAL BANK & ITS FUNCTIONS?

The leader and supervisor of all the commercial banks of a country is called Central Bank. It is the backbone of the economy and control all the banking system. In our country the Central bank is State Bank of Pakistan.

Definition:
"An institution charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of general public welfare"(KENT)

Definition:
"The general principles of central bank is that it should act only in public interest for the welfare of country as a whole and without regard to profit as a primary consideration".(DECOCK)

Definition:
"A bank, which control credit." (W.A.SHAW)

Definition in simple words:
Central bank of a country supervises controls and manages all the banking system of that country.

The functions of Central Bank are:

Monopoly of note issues:
Central bank has a monopoly of note issue. No bank issue notes. In Pakistan State Bank of Pakistan issues notes according to the need of public under two principles:

- currency principles
- proportionate reserve system

1. Banker to Government:

Central bank performs following functions as a banker to the government.

Account holder:
It keeps government deposit and makes payment on government behalf.

Lender to the Government:

It grants loan to the Govt. and also makes investment in Govt. bills and securities.

Public debt Management:
Central bank manages public debts and handles financial business connected with it.

Financial Advisor:
It acts as a financial advisor to the Govt.

2. Banker's Bank:

Central Bank is a banker's bank in following ways:

Maintenance of cash reserve:
Every commercial bank is required to keep a portion of its deposit as reserve with central bank. In Pakistan cash reserve ratio is 7.5% of total deposit.

Lender of last resort:
Whenever the commercial banks are in any financial problem, they take loan from the central bank at interest.

Remittance facility:
Provides remittance facility to commercial bank.

Clearing house:
It manages clearing house to perform clearance of cheques among banks.

Foreign Exchange Reserve.
All the foreign exchange and gold reserve of the country are kept under the custody of central bank.

Islamization:
Since 1981 the state bank of Pakistan has prepared a program to introduce Islamic banking system.

Inflation and deflation:
During inflation central bank contracts the amount of credit and increases the amount of credit and currency notes to stabilize the price level
Stability of exchange rates:
The central bank stabilizes the foreign exchange rates.

Grants for specialized institutes:
State bank of Pakistan provide grants to specialized financial institutions like ZTBL,ICP,PICIC,SME.

Regulation of credit:
Central bank is responsible of regulation of volume of credit in economy.

Export promotion:
State bank of Pakistan has introduced certain export schemes for promotion of exports

Training services:

It provides training facility for the less experienced staff working in different banks.

Exchange control:
The central bank manages foreign exchange transactions and enforces exchange control regulations.

Others:
Central bank performs some other duties as well. It publishes annual reports of economic development and activities, conduct surveys, deals with international agencies like World Bank, IMF, Asia Development Bank.

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Q # 18: Discuss the difference between a Central Bank & Commercial Bank in details?

Central Bank

Definition:
"An institution charged with the responsibility of managing the expansion
and contraction of the
Volume of money in the interest of general public welfare" (KENT)

Definition:
"The general principles of central bank is that it should act only in public interest for the welfare of country as a whole and without regard to profit as a primary consideration".(DECOCK)

Definition:
"A bank, which control credit." (W.A.SHAW)

Commercial Bank

Definition:
A banker is an institution which receives deposits and advances loans.(Kinely)

Definition:
A banker is a dealer in capital or more properly a dealer in money. He is an intermediary party between the borrower and the lender.(Gilbert)

Definition:
A baker collects money from those who have it spare or who are saving it out of their incomes.
It lends money to those who require it.(Crowther)

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Q # 19: define monetary policy? Discuss its objectives and methods? Or how central bank control credit in country? Or discuss the techniques of credit control?

MONETARY POLICY

Credit control by central bank:

The monetary policy refers to the measures, which are taken by the government to control the supply of money in the country.

Credit plays an important role in modern economic system. It is considered as the lifeblood of modern business. So proper control and regulation of credit is necessary for the economic stability of a country.

Definitions:

According to HANSON:

Monetary policy is mainly concerned with deciding how much money the community shall have or perhaps more correctly deciding whether to increase or decrease the volume of purchasing power.

In simple words:

Monetary policy is the management of the expansion and contraction of the volume of money for the attainment of specific objectives.

OBJECTIVES OF MONETARY POLICY

The objects of monetary policy differ from country to country according to their economic conditions. Following are the main objectives of monetary policy.

Price stability:

The main objectives of monetary policy are to stabilize the prices. Inflation and deflation both are not suitable for the economy. Monetary policy is used to coordinate between cost and price. So stability is achieved through monetary policy.

Stability of foreign exchange:

The second objective of monetary policy is to achieve the stable foreign exchange rate.

Full employment:

Monetary policy's another object is to achieve full employment but without inflation.

Economic development:

Monetary policy plays very affective role in promoting economic growth by providing adequate credit to productive sectors and discourage its use in unproductive sectors.

Improvement in standard of living:
Stander of living can be improved due to better monitory policy

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Q # 20: Define Banker and Customer? Discuss the nature of relationship between banker and customer?

INTRODUCTION:
The relation between the banker the customer is of utmost important. Both serve the society to grow and the economy to expend. Before we discuss the relationship between the banker and the customer it seems necessary that the two terms „banker‟ and „customer‟ must be clear in our mind.

BANKER:
A banker is a dealer in capital or more properly a dealer in money. He is an intermediate partly between the borrower and the lender. He borrows from one party and lends to another.

DEFINITION:
"A banker is a dealer in capital or more properly a dealer in money. He is an intermediary party between the borrower and the lender."

OR

"A bank collects money from those who have it spare or who are saving it out of their incomes. It lends money to those who require it."

CUSTOMER:
A customer is a person who maintains an account with the banker.

DEFINITION:
"A customer is a person who has some sort of account, either fixed or current account or some other relationship with a banker."

OR

"Any person may become a customer as soon as he opens an account with the bank."

"RELATIONSHIP BETWEEN BANKER AND CUSTOMER"

The relationship between banker and customer can be stated in two groups:

a. General Relationship
b. Special Relationship

Banker Customer Relationship

General Relationship Special Relationship

Debtors & Creditor Principal& Agent Mortgagor & Mortgagee
Pledger & Pledge Bailor & Bailee
Financer & Finance Advisor & Advisee
Assignor & Assignee Principal Debtor & Surety
Indemnifier & Indemnity- holder Reference & Referee
Modarib & Aamal Cordial relationship Purchaser & Seller

GENERAL RELATIONSHIP:

Debtors & Creditors:

1 When customer deposits his money with the bank:
The bank becomes the debtor of the customer and customer becomes the creditors of the bank.

2 When loan is taken by the customer from bank:
Then the customer becomes debtor and bank as creditor.

SPECIAL RELATIONSHIPS

Principal and Agent:
The customer is principal and the banker is the agent, when he collects cheques, bills of exchange, drafts, dividends and buys & sells stock and shares on behalf of his customer.

Mortgager & Mortgagee:
When loan is taken against immovable property (land and building) the relationship is created that of mortgager and mortgagee. The customer is mortgagor and banks as mortgagee.

Pledger &Pledgee:
When the customer pledges movable property with the banker as security for loan, he becomes the pledger and the banker as pledge.

This relationship is also known as pawnor & pawnee.
Bailor & Bailee:
The bank accepts valuables for safe custody from the customer. In this case customer is bailor and the banker as bailee.

Financer & Finance:
When bank advises his client on any important financial matters, bank becomes advisor and client becomes advisee.

Advisor & Advisee:
When bank advises his client on any important financial matters, bank becomes advisor and client becomes advisee.

Assignor & Assignee:
When any obligation or property is assigned to the bank then the bank becomes assignee and client becomes assignor.

Principle Debtors & Surety (guarantor):
If bank provides guarantee for its customer to a third party then the bank is called surety and the customer is called the principal debtor.

Indemnifier and indemnity holder:
"Indemnity is a contract where one party promises to save the other party from the loss caused to him by the conduct of the promisor himself or by the conduct of any other person."

When the bank makes a contract of indemnity with the customer, bank becomes indemnifier and customer becomes indemnity holder.

Reference and Referee:
When bank informs the state bank or any other authority about the financial status of a customer, bank is called referee and customer is called reference.

Modarib and Aamal:
When a banker provides finance to customer under the agreement of modaraba the relationship becomes that of modarib and aamal. The banker being modarib and the customer aamal.

Cordial relationship between Banker & Customer:
Sometimes the banker is in a position to established cordial relation with this customer by providing reliable and confidential information about the general standing of the people.

Purchaser and Seller:
Under deferred payment sale on markup mode of financing. The banker is the seller of the goods financed and the customer is the purchaser of the same.

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Q # 21 How the relations may be terminated between banker and customer?

A -Termination by Customer

1. Rate of interest not acceptable:
The customer may close his account if the rate of interest is not acceptable to him.

2. Lack of proper facilities:
If the banker does not give him such facilities as are offered by other banks then the customer may close his account.

3. Lack of services:
If the customer is not satisfied with the services of the bank then he may close his account.

4. Lack of confidence:
If the customer confidence in the bank is declining he may close his account.

5. Change of place of residence:
If the customer changes his place of residence he may close his account.

B - Termination by Banker

1. Closing of account:
The banker may close the account of a customer after giving him reasonable notice if:

2. Customer is convicted of forgery of cheque:
If the customer is convicted of forgery of cheque or bill; the bank may close hi account.

3. Habit of drawing cheques:
If he is habit of drawing cheques without sufficient fund in the account, the bank may close his account.

4. Account is not worth full:
If the customer account is not worth full, the bank may close his account.

5. Banker fears:
The banker fears that he would be harmful to him. In this case the bank may close his account.

Stopping payment

The important legal grounds for stopping payment in the account are as follows;

1. Death of a customer:
The banker shall close the account on receiving the intimation of the death of customer.

2. Insolvency of a customer:
On the receipt of notice of insolvency of a customer, the bank cannot honour the cheque drawn by the customer.

3. Insanity of a customer:
If an insanity of a customer is established, the bank will close his account.

4. Garnishee order:
If a company is winding up the order of the court, the banker then cannot honour the cheques of the customer.

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Q # 22: Discuss the rights and duties of customer and banker?

CUSTOMER'S RIGHTS AND DUTIES

Rights to draw a cheque:
A customer has a right to draw the cheque for the purpose of withdrawing his balance. He has a right to draw the cheque according to his credit balance.

Right to receive periodical statement:
A customer has a right to receive the statement of accounts from the bank. He receives the statement for knowing his balance or for other purpose.

Right of correction:
In case of over crediting or over debiting a customer has right to get his account corrected.

Right to sue bank for wrong dishonour:
If a bank dishonours cheque without any reason then customer has a right to file a suit against the bank.

Right to sue bank for disclosing secret information:
A customer has a right to sue and demand compensation if the bank fails to maintain the secrecy of his account.

DUTIES OF CUSTOMER

Presentation of cheque:
It is the duty of customer to present the cheque and other negotiable instrument during business hours. If cheque is presented after the business hours then bank may refuse to make the payment.

Cheque book in safe custody;
It is the duty of the customer to keep the cheque book in safe custody. So that no other can misuse it.

Report about theft:
It is the duty of the customer to report to the bank if cheque book is lost or theft. So that no other can misuse it.

Careful filling of cheques:
It is the duty of the customer to fill the cheques with utmost care. Because if there is an error in filling, then bank may dishonor the cheque.

Disclose forgery:
If a customer finds any forgery in the amounts of the cheque issued by him, then it should be reported to the bank. So that bank will not make the payment.

BANKER'S RIGHTS AND DUTIES

RIGHTS OF BANK:

Right of lien:

"Lien means the right to retain a property belonging to some other person until the debt payable by him has been paid."

The banker has a lien on the goods and securities of the customer, to retain until he pays his dues.The bank can sell such items after giving proper notice.

Right of set off:

"Set off means adjusting the debit balance against a credit balance."

It is the legal right of the bank to adjust the debit balance against the credit balance of the same borrow.

Charge interest or commission:

The bank has a right to claim bank charges and commission as compensation for the services provide. The services include collection of cheques, bill of exchange, dividend, etc.

Incidental charges:

The banker has the right to charge the incidental charges.

DUTIES OF BANKER:

Honour cheque:

It is the duty of the banker to honor the cheques drawn by customers. The cheques must be drawn properly and presented to bank during working hours.

Maintain secrecy of accounts:

The bank is bound to maintain the secrecy of his customer account. If the information is disclosed, the business of the customer may suffer in loss. However, the bank can disclose it under special circumstances like compulsion of law, etc.

Execution of standing orders:

The bank abides by the standing orders of the customers in making payment on his behalf such as club, library, insurance premium, etc.

Safe custody:

The banker should take care of the property deposited with it by the customer with or without charges.

Inform about closure of account:

It is the duty of the banker to inform about the closure of account.

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Q # 23: Discuss the various causes for termination of a Cheque.

OR

In what ways a banker can refuse to make the payment of Cheque.

OR

Discuss the various reasons for dishonor of a Cheque.

TERMINATION OR DISHONOR OF CHEQUE

Dishonor of cheque means a cheque returned unpaid by the banker. A bank can refuse to make the payment of a cheque under the following given circumstance:

Present after banking hours:

Cheque should be presented within mentioned banking hours; otherwise bank will not make the payment of a cheque.

Amount is not sufficient:

The bank can refuse to pay the amount of cheque if the account of a customer shows a less balance than the amount of cheque.

Branch is not particular:

If the cheque is wrongly presented to another branch in which drawer has no account then the banker can refuse to make payment of cheque.

Account is not particular:

If the cheque is not concerned to particular account the bank will not make any payment.

Date of cheque is not clear:

Date is very important factor of a cheque and a banker has a right to reject the cheque if the date is not properly entered or properly written.

Post Dated cheque:

If the cheque is presented for payment before due date of cheque, then the bank will not make the payment of cheque and returned unpaid.

Out dated cheque:

Banker can also refuse to make the payment of a cheque if the cheque holder has not presented it within six months.

Difference in amount:

If there is any difference in amounts written in words and figures; then the banker can refuse the payment of cheque.

Signature does not match:

Banker can terminate the payment of cheque, if the signature of drawer on cheque does not tally with th specimen provided to the banker.

Material alteration:

If the drawer has made the changes in amount, date or name then the banker can refuse to make the payment of cheque.

Torned cheque:

If the cheque presented to the bank for payment is wholly or partly torn or repaired, it may be returned dishonor by bank.

Lost cheque:

If the cheque of the customer has been lost and the banker has informed about this event, the bank will not make payment of this cheque.

Crossed cheque:

In case of crossed cheque cash is credited in the account of customer but if the customer presents the cheque at the counter for payment then the banker will refuse to make the payment.

Death of customer:

The banker cannot make the payment of the cheque after the notice of customer‟s death has been received. The amount relates to legal heirs.

Garnishee order:

If the court orders to the customer's bank to stop payment. The bank cannot honor any cheque.

Frozen account:

Banker will not make the payment to the customer whose account has been frozen by the government.

Closed Account:

An old customer can issue a cheque against the closed account. The banker cannot make payment for this kind of cheque.

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Q # 24: what are the kinds of Letter of credit?

Kinds of letter of credit

Revocable L.C:

A revocable L.C is that which can be cancelled or modified or amended by the opener (opening bank) without the consent of his beneficiary (exporter).

Irrevocable L.C

An irrecoverable L.C can be cancelled or amended or modified by the opening bank only with the consent of parties involved.

Confirmed Irrevocable L.C:

It cannot be amended or cancelled even if there is consent among the parties involved.

Red Clause L.C.

This L.C authorizes the exporter‟s bank to grant an advance to seller for packing, handling or purchase of goods.

Green Clause L.C:

This is an improvement over the red clause letter of credit. In addition to the facilities permissible under red clause L.C. it allows also the storage facilities.

Sight L.C:

On shipment of goods to the buyer, the sellers receive the bill of lading then complete the documents; seller gives these documents to the advising bank the advising banks see that whether these documents are in order. If these documents are in order then payment is made to the seller.

Usance L.C

If in the above case the payment is made after some days or months then such type of L.C is called usance L.C.

Non funded L.C.

In case of non-funded L.C the buyer‟s funds are involved in making the payment to the seller. Since the bank funds are not involved it is termed as non-funded L.C. The issuing bank creates a contingent liability. In this respect which is dependent upon the buyer‟s default.

Funded L.C.

In case of funded letter of credit the issuing bank makes the payment to the seller out of its own sources. Therefore it cannot create a contingent liability.

Clean L.C.

If there are no conditions to the bill and issuing bank makes payment upto the limit of credit is called the clean L.C.

Documentary L.C.

The draft drawn under this L.C. is accompanied by different documents relating to the merchandise.

Transferable L.C.

It is used where original beneficiary (exporter) is not a manufacturer. Exporter is middle man. L.C. is transferable to second beneficiary.
Exporter receives commission in this case.
Transferable is transferable in one time.

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Q # 25: What do you understand by the term letter of credit? OR

Name the parties involved in letter of credit? OR

Briefly discuss the operation of L.C?

INTRODUCTION:

Commodities are traded through importer and exporter. Both the parties may be unknown to each other. When an importer is not well known to an exporter, but the transaction is being conducted directly between importer and exporter, and then uses the services of the bank through a letter of credit. A letter of credit is a mean of making payment for the import of goods. It is issued by buyer bank in favour of the seller. The terms and conditions of the sales are also stated in it. Letter of credit is also known as "documentary credit".

DEFINITION

Simple Definition:

"It is a written undertaking given by a bank to the seller at the request and on the instructions of the buyer to pay at sight or at a determinable future date up to a stated sum of money within a prescribed time and against stipulated document".

According to Frank:

"A letter of credit is a written instrument issued by the buyer‟s bank authorizing the seller to draw in according with certain terms and conditions".

According to Pitchard:

"A letter of credit is a commitment on the part of the buyer‟s bank to pay or accept drafts drawn upon it provided such drafts do not exceed specified amount".

Parties Involved in a Letter of Credit:

There are 4 parties involved in a letter of credit. These are as follows:

Importer Or Buyer Or Opener:

The person who purchases the goods from other country and at whose request the letter of credit is opened is called the opener or the buyer.

Exporter or Seller or Beneficiary:
He is the person in whose favour; the latter of credit is opened.

Opening or Issuing Bank:
It is the bank which issues the latter of credit. It is the importers bank.

Paying bank or Negotiating Bank:
The bank which makes the payment to the exporter after receiving the letter of credit is called paying or negotiating bank. It is the exporter‟s bank.

PROCEDURE OF OPENING THE LETTER OF CREDIT

Mutual Contract:
First of all importer and exporter enters into a mutual agreement. The importer who is in need of something approaches an appropriate exporter by way of cable, mail or internet. Both the parties come to an agreement.

Performa invoice:
Exporter then prepares an importer document known as Performa invoice. In Performa invoice all details about the contract regarding name of product, its type, quality brand, name, color etc are all stated specially. This Performa invoice is sent to importer by the exporter.

Preparation of Documents:
Now the importer will prepare all the contract documents. The importer will get Performa and will provide all the particulars of contract in the Performa. The documents required in Pakistan are:

1. Valid importer license.
2. The insurance cover note.
3. An indent or Performa.

Contract with the Bank:
The importer will contract with bank and will provide all the documents regarding the agreement and will request for the letter of credit.

Application Form:
The bank will provide an application form if it found that document is correct. The importer will submit the application form with necessary details discussed between the importer and exporter like shipment insurance and total value of goods.

Undertaking from importer:
The importers bank obtains an undertaking from the application that he will purchase the documents at markup price prescribed by the SBP.

Margin Requirements:
State Bank of Pakistan decides the percentages of amount to be paid to the issuing bank by the importer. This amount is called margin requirements.

Issuance of L.C.

The negotiating bank will negotiate the draft (bill) to the opening bank. Now the documents will be forward to the opening bank in Pakistan.

Clearance of Goods:
Now the importer has in his possession the bill of lading means of which he can get the goods clear through the clearing agent.

Dispatch of forwarding note to opening bank:
The bank issuance the LC. After the completion of all the form. The bank prepares its four copies and those are distributed among the four parties.

Dispatch of letter of credit:
After the completion of copies of letter of credit the bank sends the duplicate copy and original copy to the exporter's bank and request for sending the original copy to the exporter and to retain the duplicate copy in his own file.

Obtaining the Documents of Shipment:
The exporter makes the arrangement for the shipment of the goods to the importer after the goods he got the receipt from the shipping company. This receipt is called bill of lading.

Submission of bill and documents:
The exporter submit the shipping documents in his bank. The bank checks the document and sends to the importers bank.

Term of payment and negotiation:
The negotiation bank will examine the documents carefully if the documents are in order and the terms & conditions of the L.C. have been fulfilled, so far as the exporter concerned.

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FINANCE PORTION

Q # 26: What is business finance? Discuss its importance for business enterprises?

Introduction

Finance is as important for business as blood for life. It is needed by every business in sole proprietorship the less amount of finance is needed due to small size business.

We may say that
Less finance less business. More finance more business.

Definition:

According to KRIZ & DUGGEN

Business finance is the flow of capital and credit that makes business possible.

Academic American Encyclopedia

Business finance concerns a firm's acquisition of funds and the management of these funds for various operations.

In simple words

Business finance means investing, borrowing & spending of money with proper manners for the operation of business.

Importance or need of business finance

Insurance expenses

Businessmen are not free from risks. These are chances of loss due to theft fire, flood, war and earthquake. But finance helps the business people to cover the risk of loss through insurance.

Intangible assets

These are certain products and commodities or services for which an organization is to purchase patent rights, copyrights or goodwill etc. Therefore finance become inevitable (unavoidable for their purchase)

Maintenance of assets

The fixed assets are use in the business. For the proper working of assets repairs and maintenance is necessary. This work cannot be done without finance.

Purchase of assets

When the business is setup many assets are purchase to run the business. These assets are land, building, plant and machinery furniture & fixture etc of these assets is possible with finance.

Additional investment

When we want to invest in anywhere the finance must be required for additional investment.

Need for pension funds

The employee of the company needs financial help after retirement. The company needs finance to setup a pension fund for their workers.

Purchase of goods

The purchase of goods, raw material import of goods stock of stationary and many other items ate necessary for doing the business.

Omission of mistakes

For the omission of mistake in product we need skilled persons. The hire skilled person we need finance.

Running or day to day expenses

The business dealing is carried on throughout the business life. The claims of the outside parties are to be paid on daily basis. This expense includes wages, carriage, rent, repairs, interest, commission, etc. For the payment of these expenses we need finance.

Technology

The finance helps to start research work. The innovation and technological changes are possible with finance.

Taxation

The claim of the government in the shape of sales tax, income tax, and excise duty are to be paid in money. Therefore the finance is needed to adjust these dues.

Communication expenses

The business mangers use telephone and telegraph facilities media for advertisement like radio, TV, radio, newspaper etc as tools for increasing sales. The payment of their services is made through money. The importance of finance increases during these days.

Change in business

The businessmen can change the nature of the business. The finance helps to purchase of new assets.

Expansion of business

The expansion in business is possible due to finance. The large amount of finance can produce the desired results for business expansion.

Selling on credit

Today the mostly business run on the basis of credit. For the selling on credit the businessmen need finance.

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Q # 27: what is meant by equity financing? Also explain its merits and demerits.

OR

What is meant by debt financing? Also explain its advantages and disadvantages?

EQUITY FINANCING

"The finance provide by the owner is called equity finance" "OR"

"The finance Provide by the means who plans for business and makes permanent investing in the form of land, building, machinery etc is called Owners Finance or Equity finance".

"OBJECTS OF EQUITY FINANCING"

Following are the objects of equity financing.

- To create confidence and eliminate worries.
- To Control over the finance crises.
- To provide sound finance base.
- To raise addition funds in case of needs.
- To protect them from the burden of interest.

"MERITS OF EQUITY FINANCING"

The use of equity finance (owners finance) has a number of advantages which in brief are as under.

Free From Investment:

The business concerns have not to pay interest charge on owner‟s fund.

Removing Worries:

As there is no burden of fixed interest charges on equity capital the business concern has no tension about interest burden.

Free From Repayment:

A business having equity financing has no obligation to repay or return it during the life of business.

Control over Crises:
In case of owners financing there is no risk the business firm can control over the financial and economic crises.

Benefit of Whole profit:
In case of owners finance the owner enjoys the full benefit due to sole claim on entire profit. In this type of finance interest is not payable to creditors.

Winding Capital:
In Case of owners financing it business is wound up the assets may remain in the hand of owners.

Reduction in Cost Price:
The cost of production will be low as there is no burden of interest.

Freedom of Control:
The owner of the business enjoys the freedom of control because no one can claim right on the assets of the company.

Concentration in quality production:
The owner can concentrate in the production and products as he ahs not tension of interest.

Financial Base:
The fund supplied by the owners providing a financial base to the capital structure of a business.

"DEMERITS OF EQUITY FINANCING"

The main disadvantages of equity financing of a business are as follows.

Risky Enterprises:
When a business uses its own capital for investment in business, it avoids taking risk. The return on sage investments low.

Chances of expansion of business:
In equity financing the chances of expansion of business are very low.

Inability for payment:
In case of loss due to business crises equity financing firms show its inability to meet the current transaction of the business.

Insufficient profit:
When businessmen does not depend upon borrowed capital and invests funds only he is then not in a position to enhanced profit during period of prosperity.

Payment of more income tax:

When businessman uses owner‟s funds only he has to pay more income taxes to the government, as share of profit paid to the owner is not deductible for income tax purpose. But in case of credit financing the interest paid to creditors may be deducted from income.

Limited funds:

In case of owners financing only the business firm cannot get sufficient amount of capital in time of need for introduction of innovation and modernization of business.

Idle funds:

If the firm's business is subject to reason, the owner‟s funds would remain idle in cash balances by which the volume of income is greatly affected.

Non-aggressive management:

A firm not using debt showing non-aggressive management.

Debt Financing

"Debt financing consist of borrowing funds which is obtained on interest from financing institution and money lender etc by agreement."

Merits of debt financing:

Tax advantages:

Interest is paid on debt financing which is deducted from profit. Therefore profit reduces and business enjoys the low taxation.

More profit:

The business concerns with the help of borrowed capital are able to earn profit.

Expansion of business:

The business concerns with the use of borrowed capital are in a position to expand the business.

Saves the firms from dissolution:

Credit financing helps the business to take over the financial difficulties and thus saves it from dissolution.

Helpful for sick business:

Debts are helpful to cure the disease of sick business. The sick business can contribute toward the national income through increased efficiency.

Low interest:

The interest charges on debt are low than the rate of return.

Seasonal business:

The borrowed money can easily finance the seasonal business. These funds are repaid as soon as the need is fulfilled.

Useful for urgent current expenses:

The business concern can take short term loans from commercial banks and other sources for meeting the urgent expenses at the peak operation of a business.

Convenience:

It is very convenient to purchase all goods on credit vases instead of paying cash on or before delivery.

Stability in life:

The firm is in a position to control over the financial problems and emergencies by debt financing.

Demerits of debt financing

Not free form interest:

Debt financing is not free form interest businessman has to pay interest on this type of debts.

No free form repayment:

There is a liability on the shoulder of businessman to repay the owner‟s financing.

Worries:

If business depends upon debts finance it they create worries.

Non availability of funds in depression:

In time of slack business the rate of return on borrowed capital is normally low as compared to the rate of interest. Therefore funds are not available for business.

Risk of heavy losses:

The business depends on the borrowed money possess less potential to face any loss. Once it suffers loss it becomes cumulative in nature.

Chances of sue:

If the principal amount is not paid on due date the creditors can sue for the payment.

Loss at the time of winding up:

In case of debt financing if business is windup the assets are not remained in the hands of owner.

Discouragement of investment:

In period of depression when firm would be given a lower percentage return as compare with interest on borrowed funds to creditors, the new investors will not contribute their funds in the business sector.