SYLLABUS

Class: - B.B.A. II Semester

Subject: - Economics II

UNIT – I	National Income: Meaning, Definition and importance of Macro Economics – National Income: Meaning, Definitions: National Income, GNP & NNP, GDP & NDP, Personal Income (PI), Disposable Income (Di), Per Capita Income (PCI), Real National Income (RNI)
UNIT – II	Theories of Employment: Classical theory of employment – Say's law of markers – Keynesian theory of employment – Consumption function – APC, MPC, factors influencing consumption function – Investment function – MEC and Rate and Rate of Interest
UNIT – III	Money And Theories Of Money: Meaning, functions and classification of Money– Gresham's law – R.B.I. Classification of Money – M1, M2, M3, M4 Theories of Money – Fisher's quantity theory of Money, Cambridge approach (Marshall, Pigou, Robertson and Keynes).
UNIT – IV	Trade Cycle and Inflation: Trade cycles – Meaning and definition – Phases of a trade cycle – Inflation – Definition – Types of Inflation – Causes and effects of inflation – Measures to control inflation.
UNIT – V	Banking, Stock Market And Insurance: Functions of Commercial banks – The process of credit creation – Concept of Non Banking Finance Companies (NBFCs) –
UNIT-VI	Concept of SEBI Stock Market – Meaning, functions and importance of Stock Market – Primary and Secondary Markets, Concepts of (a) Shares (b) Debentures, Insurance – Types of Insurance – Life Insurance and General Insurance – Functions of the Reserve bank of India – Methods of credit control – Quantitative and Qualitative Methods.

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UNIT-I
MACRO

Definitions of Macro Economics

1) **According to culberton's-**"Macro economic theory of income employment price and money."
2) **Accordingly to K.E. Boulding –**"Macro economics deals not with individuals quantities as such but with aggregate income but with national income, not with individuals price but with price levels, not with individuals output but with national output."
3) **According to Edward Shapiro –**Macro economics attempts to answer the truly 'big' question of economic life – full employment or unemployment, capacity or under capacity production.

Nature of Macro Economics

1) Macro economics studies the concept of national income and its different elements and the method of measurement.
2) It studies problems relating to employment and unemployment. It studies different factors determining the level of employment.
3) Determination of general price level is also studied under macro economics. Problems relating to inflation and deflation are an important component of macro economics.
4) Change in demand and supply of money have an important impact on the level of employment. Macroeconomics studies function of money & theories relating to it.
5) Problems relating to economic growth is another important component of macro economics like plans for overall increase in national income, output, employment are framed so the economic development of economy as a whole.
6) It also studies issues relating to international trade, export, import exchange rate and balance of payments are the principal issue in this context.

Importance of Macro Economics

1) Macro economics is helpful for getting us an idea of the functioning of an economic system it is very essential for a proper and adequate knowledge of behavior pattern of the aggregative variable, as the description of a large and complex economic system.
2) It says about the study of national income and social accounts. It is the study of national income which enables us to know that three fourth of the world is living in object poverty without proper national difficult to formulate proper economic policies.
3) Macroeconomic approaches are of almost importance to analyze and understand the effect of inflation and deflation different sections of society are affected differently as a result of charges in the value of money.
4) Economic fluctuation is a characteristics features of the capitalist form of economy. The economic booms and depression in the level of income and employment follow one another in cyclical fashion.
5) The study of macro economics is essential for the proper understanding of Micro economics. No micro economics law could be framed without a prior study of the aggregate.

Microeconomics v/s Macroeconomics

S.No.	Points	Microeconomics	Macroeconomics
1	**Study**	It studies individual unit	It studies aggregate or group of individual units.
2	**Assumption**	At micro level full employment is assumed which is never found in an economy. Hence this is an unreal assumption	At macro level, full employment is not assumed. Instead equilibrium employment is assumed which is a real assumption.

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3	**Subject Matter**	We study demand supply, consumer behavior production, types of market, theory of cost & revenue etc.	We study national income, theory of wage, interest & employment. Theory of money, theory of international trade etc.
4	**Applicability**	It is useful in analysis of an individual unit like cost of an individual good, demand of a single good, price of a single good.	It is useful in analysis of aggregate units such as aggregate demand, aggregate prices or inflation-deflation, aggregate or national income etc.
5	**Usefulness to Govt.**	It is less useful to Govt. in formulating economic policies.	It is more useful to Govt. in formulating economic policies.

Limitations of Macroeconomics

1) **Individual unit is ignored:** While studying macroeconomics, individual unit is ignored, one cannot think of increasing national saving at the expense of individual welfare.
2) **It overlooks individual differences**: Macro analysis overlooks individual differences for e.g.: overall prices in the economy may b stable but price of petrol is increasing day by day. This puts a burden on common man.
3) **Too much stress on macro analysis:** Too much stress on macro analysis is also one of the limitations of macro economics. For e.g. An economy may be growing due to yearly over year rise in GDP but if the wealth is concentrated in the hands of few rich people. From developmental point of view this is not an ideal condition.

DEFINITIONS OF NATIONAL INCOME

Marshall's Definition

"The labour and capital of a country acting on its natural resources produce annually a certain net aggregate of commodities, material and immaterial, including services of all kinds. This is the true net annual income or revenue of the country or national dividend."

The main defects of marshall's definition are as under

1. A country produces a number of commodities and services whose correct evolution becomes difficult. Thus ,we cannot get an accurate estimate of the national income of a country.

2. There are some commodities which are used more than once. Thus, there is a possibility that the product of such commodities may be counted twice. This will give a wrong estimate of the national income.

3. There are some commodities which do not appear in the market and they are consumed directly by the producers. This normally happens in the case of agricultural commodities. Marshall's definition fails to provide a measure for such items.

Pigou's Definition

"National income is that part of the objective income of the community, including of course income derived from abroad, which can be measured in money."

The limitations of this definition are as following:

1. While calculating national income, Pigou includes only those goods and services which are exchanged for money. Thus, the services which a person renders to himself ,and those which he performs for the sake of his family or friends should not be regarded as part of national dividend. Thus, the definition does not provide a correct picture of the national income of a country.

2. This definition is applicable only to developed countries of the world where barter system is not found. It cannot be used to calculate of the national income of the backward and less developed countries where the barter system still occupies an important place in the economy.

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CONCEPTS OF NATIONAL INCOME

There are different concepts of National Income, namely; GNP, GDP, NNP, Personal Income and Disposable Income.

1) Gross Domestic Product (GDP): GDP at market price is sum total of all the goods and services produced in a country during a year within the domestic territory

2) Gross National Product (GNP): GNP at market price is sum total of all the goods and services produced in a country during a year and net income from abroad. GNP is the sum of Gross Domestic Product at Market Price and Net Factor Income from abroad

3) GDP at Market Price: If we multiply the total output produced in one year within the domestic territory , by their 'Market Prices', we get GDP at market price.

4) GNP at Market Price : If we multiply the total output produced in one year within the domestic territory as well as outside the country , by their 'Market Prices', we get GNP at market price.

5) Gross Domestic Product at Factor Cost : The gross domestic product at factor cost is the difference between gross domestic product at market price and net indirect taxes.

6) Gross National Product at Factor Cost : The gross national product at factor cost is the difference between gross national product at market prices and net indirect taxes.

Private Income

Central Statistical Organization defines Private Income as "the total of factor income from all sources and current transfers from the government and rest of the world accruing to private sector" or in other words the private income refers to the income from socially accepted source including retained income of corporation.

NI+ Transfer payment + Interest on public debt +Social security + Profit and Surplus of public enterprises = Private Income

Personal Income

Prof. Peterson defines Personal Income as "the income actually received by persons from all sources in the form of current transfer payments and factor income. In other words, Private Income is the Total income received by the citizens of a country from all sources before direct taxes in a year.

PI = Private Income + Undistributed Corporate Profits – Direct Taxes

Disposable Income

Prof. Peterson defined Disposable Income as "the income remaining with individuals after deduction of all taxes levied against their income and their property by the government."

Disposable Income refers to the income actually received by the households from all sources. The individual can dispose this income according to his wish, as it is derived after deducting direct taxes.

DI = Personal Income - Direct taxes – Miscellaneous receipt of the government.

Methods of calculating National Income

Value added or production or output approach

1) The output approach focuses on finding the total output of a nation by directly finding the total value of all goods and services a nation produces.

2) Problem of Double counting: Because of the complication of the multiple stages in the production of a good or service, only the final value of a good or service is included in the total output. This avoids an issue often called 'double counting', wherein the total value of a good is included several times in national output, by counting it repeatedly in several stages of production. In the example of meat production, the value of the good from the farm may be Rs10, then Rs 30 from the butchers, and then Rs 60 from the supermarket. The value that should be included in final national output should be Rs 60, not the sum of all those numbers, Rs 90. The values added at each stage of production over the previous stage are respectively Rs 10, Rs 20, and Rs 30. Their sum gives an alternative way of calculating the value of final output.

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Income method

The income approach equates the total output of a nation to the total factor income received by residents or citizens of the nation. The main types of factor income are:

- Employee compensation/ salaries & wages (cost of fringe benefits, including unemployment, health, and retirement benefits);
- Interest received net of interest paid;
- Rental income (mainly for the use of real estate) net of expenses of landlords;
- Royalties paid for the use of intellectual property and extractable natural resources.
- Corporate Profits

Expenditure or Consumption method

The expenditure approach is basically an output accounting method. It focuses on finding the total output of a nation by finding the total amount of money spent. This is acceptable, because like income, the total value of all goods is equal to the total amount of money spent on goods

GDP= C+I+G+(X-M)

Where:
C = household consumption expenditures / personal consumption expenditures
I = gross private domestic investment
G = government consumption and gross investment expenditures
X = gross exports of goods and services
M = gross imports of goods and services
Note: (**X** - **M**) is often written as $\mathbf{X_N}$, which stands for "net exports"

Concepts of national Income

Following are the basic concepts of National Income. The study of these concepts is essential to understand various forms of National Income.

1) Gross Income - Depreciation of Capital goods = Net Income

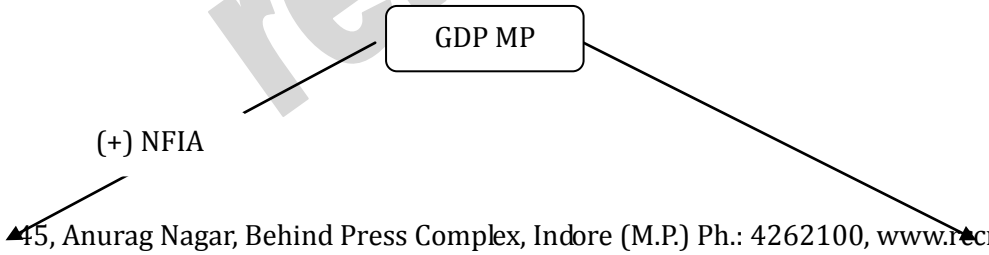
2) Domestic Income + NFIA = National Income

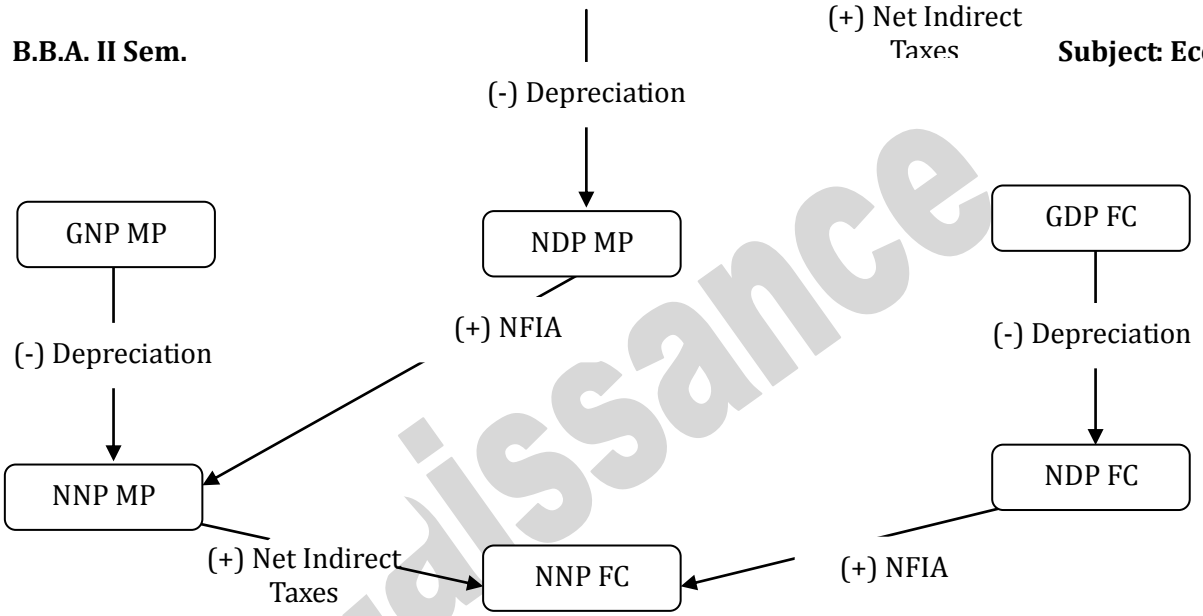
Where, NFIA = Net factor income from abroad =
(Income earned by citizens of a country residing & working abroad)

- (income earned by foreigners residing & working in India)

3) Income at M.P. + Net Indirect Taxes = Income at F.C.
Where M.P. = Market Price
F.C. = Factor cost

We can now derive various forms of National Income, starting with G.D.P. M.P.





Following basic concepts should be remembered while defining various forms of National Income.

Terms in Notation	Definition
Gross	including depreciation
Net	Excluding depreciation
Domestic	Within the domestic territory
M.P. or market price	At market price
F.C. or factor cost	At factor cost

Now we can define the various terms keeping above concepts in mind.

1) **GDP_{MP}** – It is the total value of final goods & services produced by the residents of a country within the domestic territory of country, including depreciation, at market price.
2) **GNP_{MP}** – It is the value of final goods & services produced by the residents within & outside domestic territory, including depreciation at market price.
3) **NDP_{MP}** – It is the total value of final goods & services produced by the residents of a country within the domestic territory, excluding depreciation at market price.
4) **GDP_{MP}** – It is the final value of goods & services produced by the residents within domestic territory of a country, including depreciation, at factor cost.
5) **NNP_{MP}** – It is the final value of goods & services product by the residents within & outside domestic territory, excluding depreciation, at market price.
6) **NNP_{MP}** –It is the final value of goods & services produced by the residents within outside domestic territory, excluding depreciation, at factor cost.

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UNIT-II
THEORIES OF UNEMPLOYMENT

Types of unemployment

1) **Frictional unemployment** : Frictional unemployment is a kind of unemployment that occurs when people are "between jobs" or are looking for their first jobs. It is a kind of unemployment that occurs when the economy is trying to match people and jobs correctly. So, if you get fired for poor work, if you quit because you dislike your job, or if you are just looking for your first job, you are frictionally unemployed.
2) **Seasonal unemployment** : Seasonal unemployment occurs when people are not working because their jobs only exist at some times of the year. Agricultural and construction workers are examples of this type of unemployment.
3) **Structural unemployment** Structural unemployment occurs when a given set of skills is no longer needed in a given economy. For example, E.g. closure of mines, left many miners struggling to find suitable work. For example, there may be jobs available in the service sector, but unemployed miners don't have the relevant skills to be able to take the jobs
4) **Cyclical unemployment** : Cyclical unemployment, which economists say is the worst kind. In this kind of unemployment, people are out of work because the economy has slowed and there is no demand for whatever the workers make. This sort of unemployment occurs during recessions.
5) **Voluntary unemployment:** is a situation when a person is unemployed because of not being able to find employment of his/her own choice. It is a situation when a person is unemployed. Sometimes people reject employment opportunities if they do not receive desired wages or if they are not offered the kind of work they wish to do.
6) **Disguised Unemployment:** Disguised unemployment is the most widespread type of unemployment in under-developed countries. In under-developed countries, the stock of capital does not grow fast. The capital stock has not been growing at a rate fast enough to keep pace with the growth of population, the country's capacity to offer productive employment to the new entrants to the labour market has been severely limited. This manifests itself generally in two ways: (i) the prevalence of large-scale unemployment in the urban areas; and (ii) in the form of growing numbers engaged in agriculture, resulting in *'disguised unemployment'*

Classical Theory of Unemployment

The classical theory of employment is based on the following assumptions.

1. There is existence of full employment without inflation.
2. There is a closed laissez-faire capitalistic economy.
3. There is perfect competition in labor market and product market.
4. Labor is homogenous.
5. Total out put of the economy is divided between consumption and investment expenditure.
6. The quantity of money is given.
7. Wages and prices are flexible.
8. Money wages and real wages are directly related and proportional.

The main Postulates of classical theory are:

1) The basic contention of classical economists was that if wages and prices were flexible, a competitive market economy would always operate at full employment. That is, economic forces would always be generated so as to ensure that the demand for labour was always equal to its supply.
2) In the classical model the equilibrium levels of income and employment were supposed to be determined largely in the labour market. At lower wage rate more workers will be employed. That is why the demand curve for labour is downward sloping. The supply curve of labour is upward sloping because the higher the wage rate, the greater the supply of labour.

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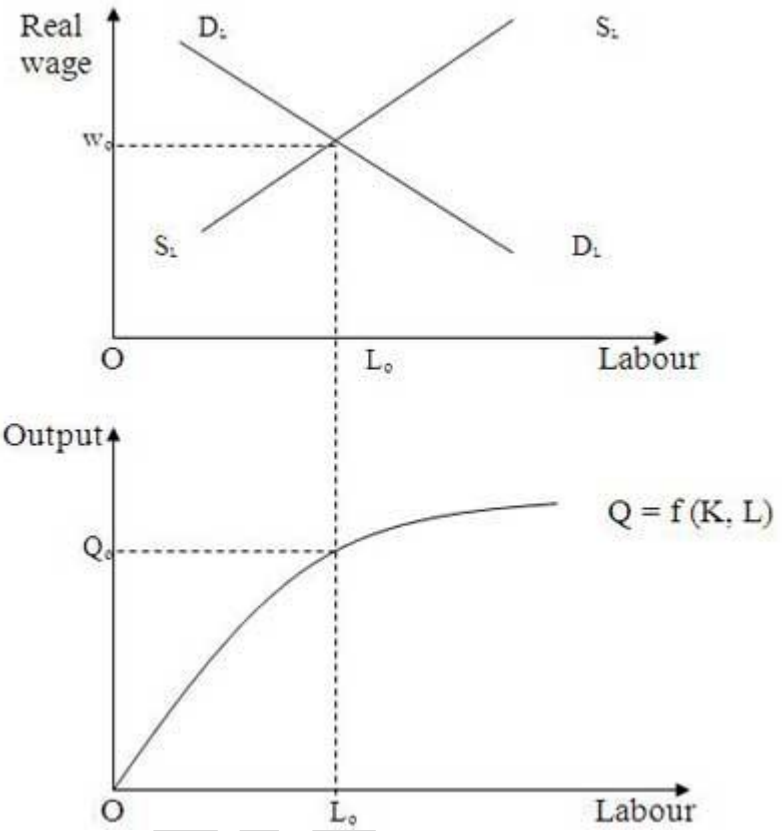
In the following figure the equilibrium wage rate (w_o) is determined by the demand for and the supply of labour. The level of employment is OL_o.



The lower panel of the diagram shows the relation between total output and the quantity of the variable factor (labour). It shows the short-run production function which is expressed as Q = f (K, L), where Q is output, K is the fixed quantity of capital and L is the variable factor labour. Total output Q_o is produced with the employment of Lo units of labour. According to classical economists this equilibrium level of employment is the 'full employment' level. So the existence of unemployed workers was a logical impossibility. Any unemployment which existed at the equilibrium wage rate (W_o) was due to frictions or restrictive practices in the economy in nature.

3) The classical economists believed that aggregate demand would always be sufficient to absorb the full capacity output Q_o. In other words, they denied the possibility of under spending or overproduction. This belief has its root in Say's Law.

(a) Say's Law: According to Say's Law supply creates its own demand, i.e., the very act of producing goods and services generates an amount of income equal to the value of the goods produced. Say's Law can be easily understood under barter system where people produced (supply) goods to demand other equivalent goods. So, demand must be the same as supply. Say's Law is equally applicable in a modern economy. The circular flow of income model suggests this sort of relationship. For instance, the income created from producing goods would be just sufficient to demand the goods produced.

(b) Saving-Investment Equality: There is a serious omission in Say's Law. If the recipients of income in this simple model save a portion of their income, consumption expenditure will fall short of total output and supply would no longer create its own demand. Consequently there would be unsold goods, falling prices, reduction of production, unemployment and falling incomes.

However, the classical economists ruled out this possibility because they believed that whatever is saved by households will be invested by firms. That is, investment would occur to fill any consumption gap caused by savings leakage. Thus, Say's Law will hold and the level of national income and employment will remain unaffected.

(c) Saving-Investment Equality in the Money Market: The classical economists also argued that capitalism contained a very special market – the money market – which would ensure saving investment equality and thus would guarantee full employment. According to them the rate of interest was determined by the demand for and supply of capital. The demand for capital is investment and its supply is saving. The equilibrium rate of interest is determined by the saving-investment equality. Any imbalance between saving and investment would be corrected by the rate of interest. If saving exceeds investment, the rate of interest will fall. This will stimulate investment and the process will continue until the equality is restored. The converse is also true.

(d) Price Flexibility: The classical economists further believed that even if the rate of interest fails to equate saving and investment, any resulting decline in total spending would be neutralized by proportionate decline in the price level. That is, Rs 100 will buy two shirts at Rs 50, but Rs 50 will also buy two shirts if the price falls to Rs 25. Therefore, if households saves more than firms would invest, the resulting fall in spending would not lead to decline in real output, real income and the level of employment provided product prices also fall in the same proportion.

(e) Wage Flexibility: The classical economists also believed that a decline in product demand would lead to a fall in the demand for labour resulting in unemployment. However, the wage rate would also fall and competition among unemployed workers would force them to accept lower wages rather than remain unemployed. The process will continue until the wage rate falls enough to clear the labour market. So a new lower equilibrium wage rate will be established. Thus, involuntary unemployment was logical impossibility in the classical model.

Says law of market

1) Say's Law is the foundation of classical economics. Assumption of full employment as a normal condition of a free market economy is justified by classical economists by a law known as 'Say's Law of Markets'. It was the theory on the basis of which classical economists thought that general over-production and general unemployment are not possible.
2) Say's law states that the production of goods creates its own demand

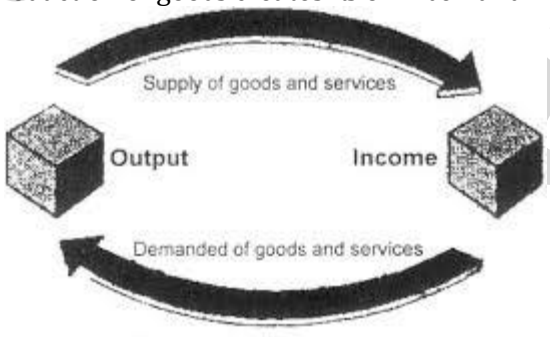


Fig: 32.1

The basic consumptions of says law are :

(a) Perfectly competitive market and free exchange economy.

(b) Free flow of money incomes. All the savings must be immediately invested and all the income must be immediately spent.

(c) **Savings are equal to investment** and equality must bring about by flexible interest rate.
(d) **No intervention of government** in market operations, i.e., a laissez faire economy, and there is no government expenditure, taxation and subsidies.
(e) Market size is limited by the volume of production and **aggregate demand is equal to aggregate supply.**
(f) It is a **closed economy.**

The Says law has the following implications:

1. **Production creates market (demand) for goods**: when the producer obtained the various inputs to be used in the production process they generate the necessary income.
2. **Barter system is its basis**: in its original form the law is applicable to a barter economy where goods are ultimately sold for goods. Therefore, whatever produced is ultimately consumed in the economy.
3. **General over production is impossible**: if the production process is continuing under normal condition, then there will be no deficiency for the producer in the market. According to say, work being unpleasant no person will work to make a product unless he wants to exchange it for some other product which he desires therefore the very act of supplying goods implies a demand for them. In such a situation there cannot be general overproduction because the supply of goods will not exceed demand as a whole.
4. **Saving investment Equality**: Income occurring to the factors owners in the form of rent, wages and interest is not spent on consumption but some proportion out of it is saved which is automatically invested for further production.
5. **Rate of interest as a determinant factor**: If there is any gap between saving and investment, the rate of interest brings about the equality between two.
6. **Flexibility between interest and wage rate**: The theory assumes the part of income is saved and available for investment. If at any point of time saving is more then investment, the rate of interest will fall, which will result in low savings and more investments. At a lower rate of interest, household will like to save less, where as producers will like or invest more and economy will be in equilibrium.If there are unemployed persons in an economy, wage rate will fall. This will induce entrepreneurs to demand more labor. Ultimately all labor will be absorbed. The economy will be in full employment equilibrium.

This view suggests that the key to economic growth is not increasing demand, but increasing production. Say's views were expanded on by classical economists, such as James Mill and David Ricardo.

Keynesian *Theory of Employment*

1) Keynes has strongly criticised the classical theory in his book 'General Theory of Employment, Interest and Money'. His theory of employment is widely accepted by modern economists. Keynesian economics is also known as 'new economics' and *'economic* revolution'. Keynes has invented new tools and techniques of economic analysis such as consumption function, multiplier, marginal efficiency of capital, liquidity preference, effective demand, etc.
2) In the short run, it is assumed by Keynes that capital equipment, population, technical knowledge, and labour efficiency remain constant. That is why, according to Keynesian theory, volume of employment depends on the level of national income and output. Increase in national income would mean increase in employment. The larger the national income the larger the employment level and vice versa. That is why, the theory of Keynes is known as *'theory of employment'* and *'theory of income'.*

Keynes Theory can be explained as:

1) **Effective Demand:** According to Keynes, the level of employment in the short run depends on aggregate effective demand for goods in the country. Greater the aggregate effective demand, the greater will be the volume of employment and vice versa. According to Keynes, the unemployment is the result of deficiency of effective demand. Effective demand represents the total money spent on consumption and investment. The equation is:

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Effective demand = National Income (Y) = National Output (O)

The deficiency of effective demand is due to the gap between income and consumption. The gap can be filled up by increasing investment and hence effective demand, in order to maintain employment at a high level.

2) According to Keynes, the level of employment in effective demand depends on two factors:

(a) Aggregate supply function, and

(b) Aggregate demand function.

(a) Aggregate supply function:

1. According to Dillard, the minimum price or proceeds which will induce employment on a given scale, is called the *'aggregate supply price'* of that amount of employment.
2. If the output does not fetch sufficient price so as to cover the cost, the entrepreneurs will employ less number of workers.
3. Therefore, different numbers of workers will be employed at different supply prices.
4. Thus, the aggregate supply price is a schedule of the minimum amount of proceeds required to induce varying quantities of employment.
5. We can have a corresponding aggregate supply price curve or aggregate supply function, which slopes upward to right.

(b) Aggregate demand function:

1. The essence of aggregate demand function is that the greater the number of workers employed, the larger the output. That is, the aggregate demand price increases as the amount of employment increases, and vice versa.
2. The aggregate demand is different from the demand for a product. The aggregate demand price represents the expected receipts when a given volume of employment is offered to workers.
3. The aggregate demand curve or aggregate demand function represents a schedule of the proceeds of the output produced by different methods of employment.

Consumption Function

The consumption function is a mathematical formula laid out by famed economist John Maynard Keynes. The formula was designed to show the relationship between real disposable income and consumer spending, the latter variable being what Keynes considered the most important determinant of short-term demand in an economy.

Definition:

Consumption function refers to the functional relationship between aggregate consumption and aggregate income C = f(y). The schedule shows the various amount of consumption at various levels of income. This shows that when income increases, consumption also increases, but in a lesser proportion (i.e.) the proportion of income spent on consumption goes on falling as income increases.

Factors Affecting consumption function

(A) Objective factors influencing the consumption function:

- First of all the households consumption expenditure depends on their income level. The consumption expenditure can be partly autonomous and partly dependent on disposable income. Disposable income is income minus personal or direct taxation. Thus C = f (Yd) where C = Consumption, Yd = disposable. Keynes psychological law status that as income increases, consumption also increases - but less than proportionately. Every increased income is generally divided into consumption and savings.

- Secondly consumption depends upon the distribution of national income. If the national income is properly distributed, then people's income that is the per capita income will be high and they will consume more.
- **Price level:** The consumption pattern of the individuals not only depend upon the money income, but also the price level. Thus, during inflation, their consumption power is less and vice versa.
- **Wages:** The consumption pattern largely depends upon the wages also, whether their remuneration is received in the form of cash or in kind.
- **Unexpected profits and losses:** If the individuals are self employed people or business man, then their consumption pattern mostly depends on their profit and loss. Unexpectedly, if they gain more, then their consumption pattern is high.
- **Liquidity preference:** If people prefer to hold more and more liquid cash, then their present consumption will be low.
- **Rate of Interest:** If the interest is high, then people will forgo the present consumption and postpone it for a future date. Higher the rate of interest payable, lesser will be purchasing power. This will certainly reduce the consumption.
- **Future expectations:** If the demand for cash to make speculative gains is more, then the present consumption will be low.
- **Permanent income:** The people who have permanent income either from earned or unearned income, there consumption will be more.
- **Advertisement:** If the advertisement and publicity can induce the people more effectively, then the consumption of the people for such commodities will be more.
- **Credit facilities:** If goods can be purchased by taking loans, individuals spend more on consumption.

(B) Subjective factors influencing consumption function:
There are some psychological motives which encourage savings and discourage consumption.
They are as follows:
(a) Motive of precaution: The desire to save for meeting unforeseen emergencies in future.
(b) Motive of foresight: The desire to build reserves for meeting old age needs.
(c) Motive of calculation: The desire to save for earning interest.
(d) Motive of improvement: The desire to save for future progress.
(e) Motive of independence: The desire to save for attaining self reliance.
(f) Motive of pride: The desire to save for possessing wealth.
(g) Motive of enterprise: The desire to save for establishing business assets.

Motive which encourage savings among corporate sector:
(a) Motive of enterprise: The desire to create additional resources for further investment.
(b) Motive of liquidity: The desire to keep more liquid assets for meeting future emergencies.
(c) Motive of improvement: The desire to enjoy rising income.
(d) Motive of financial prudence: To arrange sufficient funds against depreciation

AVERAGE PROPENSITY TO CONSUME (APC)
The willingness to use a proportion of income (Y) for consumption (C) is known as average propensity to consume (APC): APC=C/Y As income increases, the average propensity to consume decreases. This is indeed observable in the fact that wealthy individuals consume a smaller proportion of their income than to poorer people who may in fact be force to receive money from others.

If the income of a family is Rs 50,000 and that family spends Rs 45,000 per year, the average propensity to consume is APC = 45,000/50,000 = .9 or 90%.

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MARGINAL PROPENSITY TO CONSUME (MPC)

The marginal propensity to consume (MPC) is the proportion of additional consumption (dC) which will be taking place out of an increase in income (dY): MPC=dC/dY MPC is the slope of the consumption line. It is constant throughout reflecting a stable pattern of consumption in our society.

> If the income of the family increases by Rs 1,000 and the family decides to buy an additional television worth Rs 600 with that new income, the marginal propensity to consume is MPC = 600/1000 = .6 or 60%.

SAVING

Saving is what is left from income after consumption is taken out. Saving is primarily determined by the level of real income. The higher the income, the more individuals are willing and able to save.

> Saving is what will permit consumption in the future. In today's society, a lot of saving is institutional. For instance, social security contributions and pension plan deductions are a form of saving.

AVERAGE PROPENSITY TO SAVE

The willingness of individuals to save (S) a proportion of their income is called average propensity to save (APS): APS=S/Y.

> If a family earns Rs 50,000 and saves Rs 5,000 each year, the average propensity to save is APS = 5,000/50,000 = .1 or 10%.

MARGINAL PROPENSITY TO SAVE (MPS)

The marginal propensity to save (MPS) is the proportion of additional saving (dS) out of an additional income (dY): MPS=dS/dY The marginal propensity to save is the slope of the savings line. Since income can only be consumed or saved, the sum of the marginal propensities to consume and to save is one: MPC+MPS=1.

> If a family has an increase in income of Rs 1,000 and decides to save Rs 400 of that increase, the marginal propensity to save is MPS = 400/1,000 = 0.4 or 40%.

Marginal efficiency of capital (for marginal efficiency of investment)

Marginal efficiency of capital (MEC) is a Keynesian concept. According to J. M. Keynes, nations output depends on its stock of capital. An increase in the stock of capital increases output. The question is how much increase in investment raises output'? Well, this depends on the productivity of new capital i.e. on the marginal efficiency of capital. Marginal efficiency of capital is the rate of return expected to be obtainable on a new capital asset over its life time.

DEFINITION OF MEC:

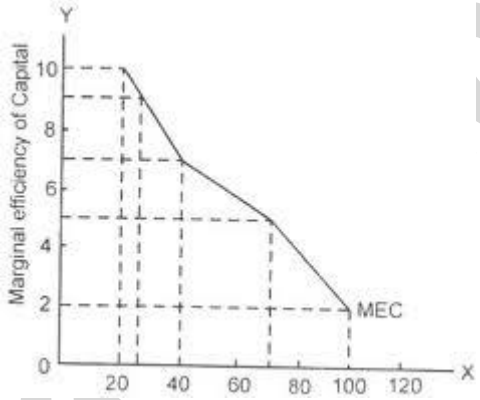
1) J. M. Keynes defines marginal efficiency of capital as "the rate of discount which makes the present value of the prospective yield from the capital asset equal to its supply price"

2) The **marginal efficiency of capital** (MEC) is that rate of discount which would equate the price of a fixed capital asset with its present discounted value of expected income.

EXAMPLE: A businessman while investing in a new capital asset, examines the expected fate of net return (profit) on it during its lifetime against the supply price of capital asset (cost of capital asset) if the expected rate of profit is greater than the replacement cost of the asset. the businessman will invest the money in the project. For example, if a businessman spends Rs. 10,000 on the purchase of a new griding machine We assume further that this new capital asset continues to produce goods over a long period of time The net return (excluding meeting all expenses except the interest cost) of the griding machine is expected to be Rs.

1000 per annum. The marginal efficiency of capital will be 10%.According to J. **M.** Keynes, the behaviour of investors in respect of new investment depends upon the various stocks of capital available in the economy at a particular period of time As the stock of capital increases in the economy, the marginal efficiency of capital goes on diminishing. The MEC curve is negatively sloped as is shown in the figure

Investment (Rs. billion)	Marginal efficiency of capital
20	10% .
25	9%
40	7%
70	5%
100	2% '



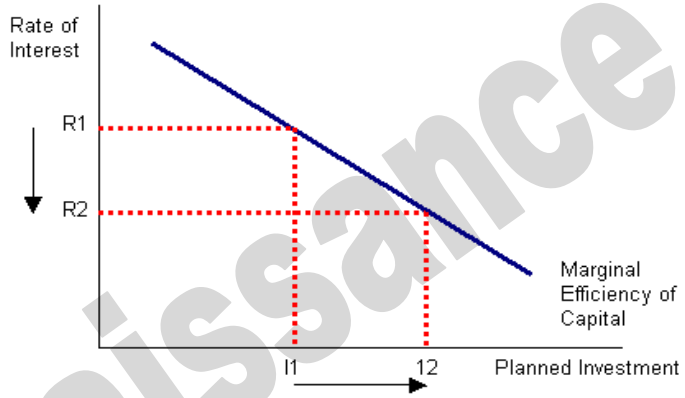
Volume of Investment →

In the above table, it is shown when stock of capital is equal to Rs. 20 billion, the marginal efficiency of capital is 10%. while at a capital stock of Rs 100 billion, it declines to 2%. This investment demand schedule when depicted graphically in figure 30.7 gives us the investment demand curve which goes on sloping downward from left to right.

MEC and the rate of interest.

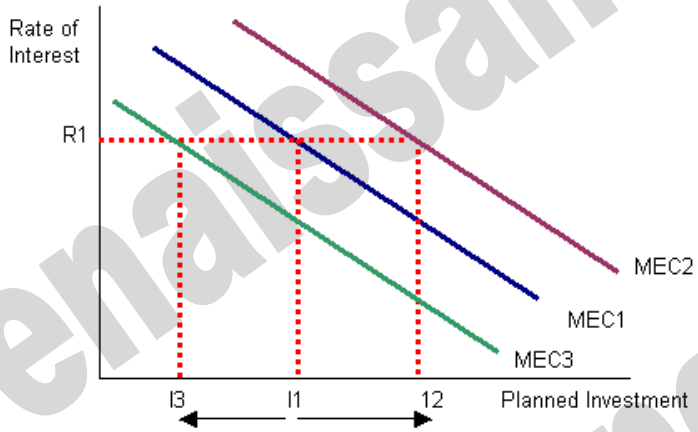
The MEC and the rate of interest are the two important factors which affect the volume of new investment in a country. An investor while making a new investment, weighs the MEC of new investment against the prevailing rate of interest As long as the MEC is higher than the rate of interest, the investment will be made till the MEC and the rate of interest are equalized For example, if the rate of interest is 7%, the induced investment will continue to be made till the MEC and the rate of interest are equalized. At 7% rate of interest, the new investment will be Rs. 40 billion. In case, the rate of interest comes down to 2%, the new investment in capital assets will be Rs. 100 billion. Summing up, if investment is to be increased in the country. either the rate of interest should go down or MEC should increase. The investment demand function is expressed as under. I = f(i, r), where i = investment demand, i = Rate of interest and r = expected rate of return or MEC.

The inverse relationship between investment and the rate of interest can be shown in a diagram (see below). The relationship between the two variables is represented by the marginal efficiency of capital investment (MEC) curve. A fall in the rate of interest from R1 to R2 causes an expansion of planned investment.



Shifts in the marginal efficiency of capital

Planned investment can change at each rate of interest. For example a rise in **the expected rates of return** on investment projects would cause an outward shift in the marginal efficiency of capital curve. This is shown by a shift from MEC1 to MEC2 in the diagram below. Conversely a fall in business confidence (perhaps because of fears of a recession) would cause a fall in expected rates of return on capital investment projects. The MEC curve shifts to the left (MEC3) and causes a fall in planned investment at each rate of interest.



B.B.A. II Sem. **Subject: Economics II**

UNIT-III

Topic 1 : Meaning functions & classification of money

Meaning of Money:

1) Money is a token or item which acts as a medium of exchange that has both legal and social acceptance with regards to making payment for buying commodities or receiving services, as well as repayment of loans.
2) In addition, money also functions as a standard of value and a store of value because with the help of money, the value of various goods and services can be measured. According to a small number of economists, money is a standard of deferred payment.
3) Money refers both to currency, specifically a large number of currencies that circulate under the legal tender status, and different types of financial deposit accounts, for example savings accounts, demand deposits, as well as certificates of deposit.
4) According to the theory of modern economy, currency is the most minuscule constituent of money supply. Money has no similarities with real value as real value is the fundamental component of the study of economics. The study of economics has a key focus on money and money is mostly associated with finance. If money is absent, then the economy becomes ineffective, and on the contrary, the efficient use of money results in increased productivity and wealth.

Functions of Money –

1) **Money as a Medium of Exchange**: - The function of money as a medium of exchange solves all the difficulties of barter system. There is no necessity for a double coincidence of wants in the money economy. The man with cow who wants to purchase cloth need not seek a cloth seller who wants a cow. He can sell his cow in the market for money and then purchase cloth with the money obtained.
2) **Money as Measure of Value**:- In money economy values of all commodities are expressed in terms of money. Money is like the yard stick of cloth merchant, as yard-stick measures all varieties of cloth, money measures the value of all varieties goods. This function of money makes transactions easy and also fair.
3) **Standard of Deferred Payment**:- In a money economy the contracts are made for future payments terms of money instead of goods and promise to repay the loan in money. In this way money is the standard of deferred payments. This function stimulates all kinds of economic activities which depend on borrowed money.
4) **Money as a Store of Value**:- Goods cannot be stored because they are perishable. People receive their incomes in money form and keep their savings in money form in banks. In this way, money is used to store value of commodities.
5) **Store of value** :- In order to be a medium of exchange, money must hold its value over time; that is, it must be a store of value. If money could not be stored for some period of time and still remain valuable in exchange, it would not solve the double coincidence of wants problem and therefore would not be adopted as a medium of exchange. As a store of value, money is not unique; many other stores of value exist, such as land, works of art, and even baseball cards and stamps. Money may not even be the best store of value because it depreciates with inflation. However, money is more liquid than most other stores of value because as a medium of exchange, it is readily accepted everywhere. Furthermore, money is an easily transported store of value that is available in a number of convenient denominations.
6) **Medium of exchange** :- Money's most important function is as a medium of exchange to facilitate transactions. Without money, all transactions would have to be conducted by barter, which involves direct exchange of one good or service for another. The difficulty with a barter system is that in order to obtain a particular good or service from a supplier, one has to possess a good or service of equal value, which the supplier also desires. In other words, in a barter system, exchange can take place only if there is a double coincidence of wants between two transacting parties. The likelihood of a double

coincidence of wants, however, is small and makes the exchange of goods and services rather difficult. Money effectively eliminates the double coincidence of wants problem by serving as a medium of exchange that is accepted in all transactions, by all parties, regardless of whether they desire each others' goods and services.

Classification of Money –

There are 4 major types of money:

- Commodity Money
- Fiat Money
- Fiduciary Money
- Commercial Bank Money

1) **Commodity Money**- It is the simplest kind of money which is used in barter system where the valuable resources fulfill the functions of money. The value of this kind of money comes from the value of resource used for the purpose. It is only limited by the scarcity of the resources. Value of this kind of money involves the parties associated with the exchange process. These money have intrinsic value.
   Whenever any commodity is used for the exchange purpose, the commodity becomes equivalent to the money and is called commodity money. There are certain types of commodity, which are used as the commodity money. Among these, there are several precious metals like gold, silver, copper and many more. Again, in many parts of the world, seashells (also known as cowrie shells), tobacco and many other items were in use as a type of money & medium of exchange.
   Ex : gold coins , beads , shells, pearls, stones, tea, sugar, metal
2) **Fiat Money** - The word fiat means the "command of the sovereign". Fiat currency is the kind of money which don't have any intrinsic value and it can't converted into valuable resource. The value of fiat money is determined by government order which makes it a legal instrument for all transaction purposes. The fiat money need to be controlled as it may affect entire economy of a country if it is misused. Today Fiat money is the basis of all the modern money system. The real value of fiat money is determined by the market forces of demand and supply.
   Ex : Paper money, Coins
3) **Fiduciary Money**- Today's monetary system is highly fiduciary. Whenever, any bank assures the customers to pay in different types of money and when the customer can sell the promise or transfer it to somebody else, it is called the fiduciary money. Fiduciary money is generally paid in gold, silver or paper money. There are cheques and bank notes, which are the examples of fiduciary money because both are some kind of token which are used as money and carry the same value.
4) **Commercial Bank Money** - Commercial Bank money or demand deposits are claims against financial institutions that can be used for the purchase of goods and services. A demand deposit account is an account from which funds can be withdrawn at any time by cheque or cash withdrawal without giving the bank or financial institution any prior notice. Banks have the legal obligation to return funds held in demand deposits immediately upon demand (or 'at call'). Demand deposit withdrawals can be performed in person, via cheques or bank drafts, using automatic teller machines (ATMs), or through online banking.

Topic 2 – Gresham's Law

1) Statement of Law - Gresham's Law states that when good and bad money are circulating together as legal tender, bad money tends to drive good money out of circulation. This principle was enunciated by Sir Thomas Gresham, Financial Adviser to Queen Elizabeth I in the 16th century in England.
2) History behind Gresham's Law - During the Elizabethan regime, a number of debased or depreciated, clipped and sweated (under- weighed) coins of previous rulers Henry VIII and others were in circulation. Queen Elizabeth, therefore, thought of reforming the currency system. She tried to replace

these bad coins of the previous regime by issuing new, full-weighted coins. She thought that eventually new coins (good money) would remain in circulation and old coins (bad money) would go out of circulation. But, to her surprise, the result was the opposite. As soon as these new coins made their appearance, they disappeared and old coins continued to remain in circulation. She consulted Sir Thomas Gresham, her Financial Adviser, in this matter. Gresham observed and explained this tendency and propounded the law that:

3) Gresham referred to the worn-out, debased, clipped or underweighted sweated coins as "bad money". Obviously, by good money he meant full-weighted legal tender. In short, bad money is inferior coin and good money is better coin under monometallic standard (where one metal alone, generally gold or silver, is freely coined and is made full legal tender).
4) When two such kinds of money are in circulation, it is natural for people to retain the better or new coins and pass on into circulation the comparatively old and worn-out or inferior coins. Thus, in course of time, better money would be driven out of circulation and replaced by inferior or bad money.

How the Law Operates

When both good and bad money circulate together as legal tender, good money disappears in three different ways:

1) Good money is hoarded and bad money is used by the people in making payments. Thus bad money remains in circulation and good money disappears owing to its hoarding.
2) Good new coins are melted by the people when they need metal for ornaments or other purposes of art as they contain more metal in them as compared to the depreciated old coins. Since, in circulation, both good coins and bad coins have the same value, people prefer to melt good coins when they want metal instead of coins; thus, good money disappears from circulation, while the bad money remains.
3) Good coins are exported abroad. Since in payments to foreign countries, under the Gold Standard, national currencies were acceptable in weight and not by counting, it was profitable to pay in terms of new full-weighted coins rather than old and bad coins were used for domestic transactions.
In this way, good money disappears from circulation leaving behind only bad money to circulate.

Topic 3- RBI Classification of Money

As per the RBI website, the types of money supply can be given as:

1. M0 - Reserve Money

M0 = Currency in Circulation + Bankers' Deposits with RBI + Other deposits with RBI

2. M1 - Narrow Money

M1 = Currency with public + Demand deposits with the Banking system + Other deposits with RBI
M1 = Currency with the Public + Current Deposits with the Banking System + Demand Liabilities Portion of Savings Deposits with the Banking System + 'Other' Deposits with the RBI

3. M2

M2 = M1 + Time Liabilities Portion of Savings Deposits with the Banking System + Certificates of Deposit issued by Banks + Term Deposits of residents with a contractual maturity of up to and including one year with the Banking System (excluding CDs)

M2 = Currency with the Public + Current Deposits with the Banking System + Savings Deposits with the Banking System + Certificates of Deposit issued by Banks + Term Deposits of residents with a contractual maturity up to and including one year with the Banking System (excluding CDs) + 'Other' Deposits with the RBI

4. M3 - Broad Money

M3 = M2 + Term Deposits of residents with a contractual maturity of over one year with the Banking System + Call/Term borrowings from 'Non-depository' Financial Corporations by the Banking System

5. M4

M4 = M3 + All deposits with post office savings banks

Topic 4 – FISHER's QUANTITY THEORY OF MONEY

DEFINITION

1) The quantity theory of money is the idea that the supply of money in an economy determines the level of prices and changes in the money supply result in proportional changes in prices.
2) In other words, the quantity theory of money states that a given percentage change in the money supply results in an equivalent level of inflation or deflation.

EQUATION

This concept is usually introduced via an equation relating money and prices to other economic variables, as shown by the following setup:

MV = PT or MV = PY

Where,

M represents the amount of money available in an economy (i.e. the money supply)
V is the velocity of money, which is how many times within a given period, on average, a unit of currency gets exchanged for goods and services
P is the overall price level in an economy
Y is the level of real output in an economy (usually referred to as real GDP)
T is the volume of trade transactions

EXAMPLE

9000*2. = 30*600

Let's consider a very simple economy where 600 units of output are produced and each unit of output sells for Rs. 30. This economy generates 600 x 30 = Rs. 18,000 of output, as shows in the right-hand side of the equation.

Now suppose that this economy has a money supply of Rs. 9,000. If it is using Rs.9,000 of currency to purchase Rs. 18,000 of output, then each dollar has to change hands twice on average. This is what the left-hand side of the equation represents.

QUANTITY EQUATION GROWTH RATE FORM

% change in (M*V) = % Change in (P*Y)
(% change in M)*(% change in V) = (% change in P)* (% change in Y)

The quantity equation can also be written in growth rates form, as shown above. Not surprisingly, the growth rates form of the quantity equation relates changes in the amount of money available in an economy and changes in the velocity of money to changes in the price level and changes in output.

Historical evidence shows that the velocity of money is pretty constant over time, so it's reasonable to believe that changes in the velocity of money are in fact equal to zero.

So, we put % change in V=0
So, we obtain, Mg= (% change in P * % change in Y)

Most economists agree that, in the long run, the level of goods and services produced in an economy depends primarily on the factors of production (labor, capital, etc.) available and the level of technology present rather

than the amount of currency circulating, which implies that the money supply cannot affect the real level of output in the long run.
So, we put % change inY= 0
So, we obtain. (Mg= % change in P)

EXTENSION OF FISHERS QUANTITY THEORY OF MONEY MV = PT

1) Fishers stated P = MV/T, which implies that the quantity of money (M) determines the prices level (P), assuming T and V to be constant. In this equation of exchange, however, only primary money or currency money is conceived. But in the modern economy, money includes not only notes and coins, but also demand deposits of banks or credit money.
2) Fisher has extended the equation of exchange to include bank deposits also. He denotes M for demand deposits in the bank money, and V for the velocity of circulation of bank money. Thus, the extended form of the equation of exchange is written as:

P = MV+M'V'/T

It is easy to see from this equation that the price level is determined by the following factors:

(a) The quantity of money in circulation (M)
(b) The velocity of circulation of money (V)
(c) The volume of bank money (M')
(d) The velocity of circulation of bank money (V'); and
(e) The volume of trade or transactions, that is, v the amount of goods bought by money (T).

The equation further denotes that the price level (P) is directly related to M, V, M' and V and it is inversely related to T.

Thus, the fundamental thesis which Prof. Fisher seeks to establish by the equation of exchange is that the price level or the value of money is a function of the quantity of money only. He regarded this equation as an important tool of analysis, including the correlation between the general price level the quantity of money.

Topic 5 – Cambridge or Cash Balance Approach to Fisher's Theory

1) The Cambridge version of quantity theory of money was first developed by Cambridge economist, Alfered Marshell. It was later modified by his followers, viz. A.C. Pigou, D.H.Robertson and also J.M.Keynes, all at Cambridge University.
2) Marshall's version is popularly known as 'Neoclassical theory of money' and 'cash balance approach'. The Cambridge quantity theory of money is a significant improvement over the classical quantity theory of money.
3) According to the Cambridge version of quantity theory of money, price level is effective only by that part of money which people hold in form of cash for transaction purpose, not only by the total MV as suggested by the classical theory.
4) According to the neoclassical economists individuals hold money or demand money for transaction purposes. In the ultimate analysis they postulated that people hold only a certain proportion of their money income for transaction purposes. They stated their hypothesis in the form of an equation.
5) The Marshallian quantity equation is expressed as:

M = KPY

Where, M stands for the quantity of money (currency + demand deposits);
P refers to the price level;
V denotes aggregate real income; and
K is the fraction of the real income which people desire to hold, in money form, as ready purchasing power.

Using the above equation, the purchasing power of money (1/P), i.e., the value of money is found out by dividing the total amount of goods which the people want to hold out of the total income (KY) by the amount of the current supply of cash (M) with them. Thus:

$$1/P = KY/M$$

(Here1/ P represents purchasing power).

It follows that KY remaining unchanged, when M increase, P, the purchasing power of money, decreases.

Marshall also shows that M and V being constant, P improves with the increase in K. In his view, K is more important than M.

DIFFERENCES BETWEEN FISHERS AND CAMBRIDGE APPROACH

1) The cash-balances model is a stock concept, whereas the transactions-velocity model is a flow concept. According to the former, the money supply is a given stock at any point in time; whereas the latter viewed money supply as a flow over a period of time. Thus, in the former V is disregarded, while in the latter V becomes indispensable.
2) Differences in the concept of Demand for Money.
3) The two versions make use of different concepts of demand for money. While the Fisherian version emphasizes the medium of exchange function of money, the Cambridge version stresses the store of value function.

ASSUMPTIONS IN QUANTITY THEORY OF MONEY

Fisher proceeds to analyse the equation of exchange along with its assumptions in the following manner:

1) **The price level (P) is a passive variable**: This means that P does not change by itself. It is determined and controlled solely by the other elements in the equation and it exerts no control over them. An increase in M or V alone will raise the price level, and vice versa, an increase in T alone will reduce the price level.
2) **The total volume of transactions (T) is an independent but constant variable in the short run**: It is not affected by any change in the quantity of money (M) and other factors in the equation, for, as Fisher says, T depends upon natural resources, technological development, population, etc., which are outside the equation so that any change in M will have no effect on T.
   The factor T can be regarded as constant over short periods of time. Since T is affected by various outside factors which normally change only slowly over time, it is not subject to rapid fluctuations.
3) **The velocity of circulation of money, V, is an independent element in the equation and is constant in the short period**: Normally, any change in M has no effect on V, for it depends upon outside factors such as payment habits of individuals and commercial customs, density of population, development of transportation. Since these factors, especially the monetary habits of the people, do not change immediately, normally V is quite a stable phenomenon so that any change in M will have no effect on. Likewise V is not affected by M'.
4) **The ratio M'/M is constant**: The magnitude of bank money (MO depends on the commercial banks' credit creation activity which in effect is a function of the currency money (M). M' is assumed to be a constant factor since the ratio M'/M', that is, the ratio of credit money to cash remains constant during the short period. According to Fisher, under any given conditions of industry and civilisation, deposits tend to hold a fixed normal ratio to money in circulation. Thus, the inclusion of M' does not normally disturb the quantitative relation between money and prices.
5) **Full Employment**: Assumption of full employment condition in the economy is implicit in the Fisherian analysis.

6) **Short Period Analysis**: Fisher categorically viewed this theory on the basis of short period consideration of changes in the variables like M, V, P and T and held V and T to be the constant elements in his equation of exchange.

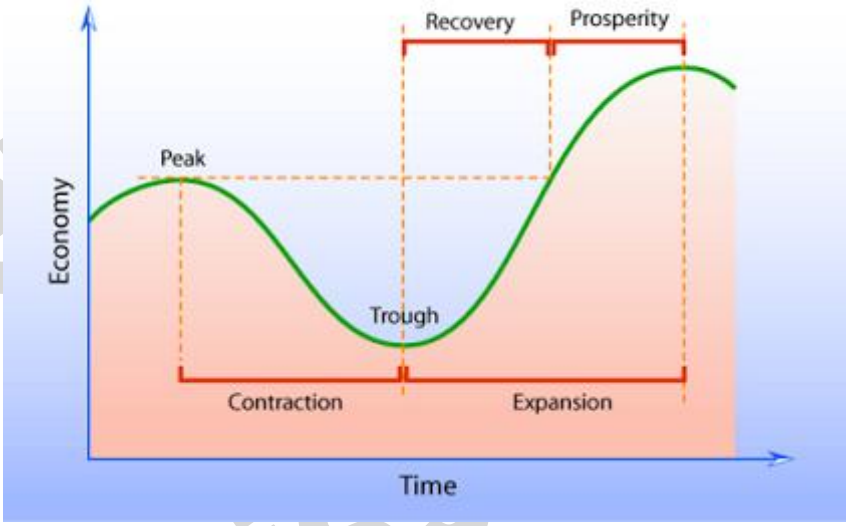
When all the elements M', V, V and T are constant and P is passive in the equation of exchange, it becomes clear that any fluctuation in the price level, P, is due to the fluctuations in M, the supply of quantity of money only. Fisher then establishes a direct relationship between the price level and the quantity of money of such a nature that the purchasing power of money becomes an immediate inverse function of its quantity.

B.B.A. II Sem. **Subject: Economics II**

Unit-IV:
Trade cycle & Inflation

Topic -1 Meaning & definition of trade cycle

The alternating periods of expansion and contraction in the economic activity has been called business cycles or **trade cycles**.



The period of high income, high output and high employment is called as the **Period of Expansion**, Upswing or Prosperity.
The period of low income, low output and low employment is called as the **Period of Contraction**, Recession, Downswing or Depression.

Definition of Trade Cycle
According to **Keynes**,
"A trade cycle is composed of periods of Good Trade, characterized by rising prices and low unemployment percentages, shifting with periods of bad trade characterized by falling prices and high unemployment percentages."

Features of Trade Cycle
The characteristics or features of trade cycle are :-

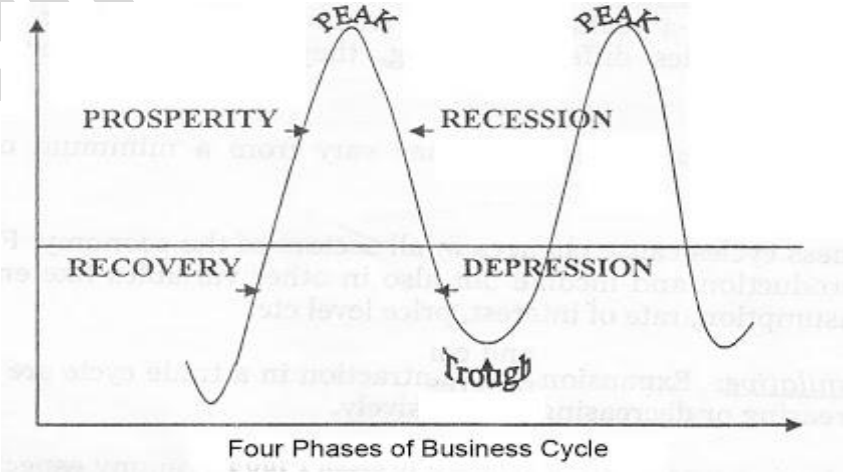
1. **Movement in Economic Activity** : A trade cycle is a wave-like movement in economic activity showing an upward trend and a downward trend in the economy.
2. **Periodical** : Trade cycles occur periodically but they do not show the same regularity.
3. **Different Phases** : Trade cycles have different phases such as Prosperity, Recession, Depression and Recovery.
4. **Different Types** : There are minor and major trade cycles. Minor trade cycles operate for 3-4 years, while major trade cycles operate for 4-8 years or more. Though trade cycles differ in timing, they have a common pattern of sequential phases.
5. **Duration** : The duration of trade cycles may vary from a minimum of 2 years to a maximum of 12 years.

6. **Dynamic** : Business cycles cause changes in all sectors of the economy. Fluctuations occur not only in production and income but also in other variables like employment, investment, consumption, rate of interest, price level, etc.
7. **Phases are Cumulative** : Expansion and contraction in a trade cycle are cumulative, in effect, i.e. increasing or decreasing progressively.
8. **Uncertainty to businessmen** : There is uncertainty in the economy, especially for the businessmen as profits fluctuate more than any other type of income.
9. **International Nature** : Trade Cycles are international in character. For e.g. Great Depression of 1930s.

Topic 2 -Phases of a Trade/Business Cycle

Business Cycle (or Trade Cycle) is divided into the following four phases :-

1. **Prosperity Phase** : Expansion or Boom or Upswing of economy.
2. **Recession Phase** : from prosperity to recession (upper turning point).
3. **Depression Phase** : Contraction or Downswing of economy.
4. **Recovery Phase** : from depression to prosperity (lower turning Point).



Four Phases of Business Cycle

The business cycle starts from a trough (lower point) and passes through a recovery phase followed by a period of expansion (upper turning point) and prosperity. After the peak point is reached there is a declining phase of recession followed by a depression. Again the business cycle continues similarly with ups and downs.

Explanation of Four Phases of Business Cycle

The four phases of a business cycle are briefly explained as follows :-

1. Prosperity Phase

When there is an expansion of output, income, employment, prices and profits, there is also a rise in the standard of living. This period is termed as Prosperity phase.

The **features of prosperity** are :-

1. High level of output and trade.
2. High level of effective demand.
3. High level of income and employment.
4. Rising interest rates.
5. Inflation.
6. Large expansion of bank credit.
7. Overall business optimism.
8. A high level of MEC (Marginal efficiency of capital) and investment.

Due to full employment of resources, the level of production is Maximum and there is a rise in **GNP** (Gross National Product). Due to a high level of economic activity, it causes a rise in prices and profits. There is an upswing in the economic activity and economy reaches its **Peak**. This is also called as a **Boom Period**.

2. Recession Phase

The turning point from prosperity to depression is termed as Recession Phase.

During a recession period, the economic activities slow down. When demand starts falling, the overproduction and future investment plans are also given up. There is a steady decline in the output, income, employment, prices and profits. The businessmen lose confidence and become pessimistic (Negative). It reduces investment. The banks and the people try to get greater liquidity, so credit also contracts. Expansion of business stops, stock market falls. Orders are cancelled and people start losing their jobs. The increase in unemployment causes a sharp decline in income and aggregate demand. Generally, recession lasts for a short period.

3. Depression Phase

When there is a continuous decrease of output, income, employment, prices and profits, there is a fall in the standard of living and depression sets in.

The **features of depression** are :-

1. Fall in volume of output and trade.
2. Fall in income and rise in unemployment.
3. Decline in consumption and demand.
4. Fall in interest rate.
5. Deflation.
6. Contraction of bank credit.
7. Overall business pessimism.
8. Fall in MEC (Marginal efficiency of capital) and investment.

In depression, there is under-utilization of resources and fall in GNP (Gross National Product). The aggregate economic activity is at the lowest, causing a decline in prices and profits until the economy reaches its **Trough** (low point).

4. Recovery Phase

The turning point from depression to expansion is termed as Recovery or **Revival** Phase.

During the period of revival or recovery, there are expansions and rise in economic activities. When demand starts rising, production increases and this causes an increase in investment. There is a steady rise in output, income, employment, prices and profits. The businessmen gain confidence and become optimistic (Positive). This increases investments. The stimulation of investment brings about the revival or recovery of the economy. The banks expand credit, business expansion takes place and stock markets are activated. There is an increase in employment, production, income and aggregate demand, prices and profits start rising, and business expands. Revival slowly emerges into prosperity, and the business cycle is repeated.

Thus we see that, during the expansionary or prosperity phase, there is inflation and during the contraction or depression phase, there is a deflation

Topic -3 Meaning & definition of Inflation

What is Inflation? Meaning

1) Inflation refers to a continuous rise in general price level which reduces the value of money or purchasing power over a period of time.

2) Statistically speaking, inflation is measured in terms of a percentage rise in the price index (i.e. percentage rate per unit time) usually for an annum (a year) or for 30-31 days (a month).

Definition of Inflation

According to **Crowther**,

"Inflation is a state in which the value of money is failing i.e. the prices are rising."

According to **Coulbourn**,

"Inflation is too much of money chasing too few goods."

Features of Inflation

The characteristics or features of inflation are as follows :-

1. Inflation involves a process of the persistent rise in prices. It involves rising trend in price level.
2. Inflation is a state of disequilibrium.
3. Inflation is scarcity oriented.
4. Inflation is dynamic in nature.
5. Inflationary price rise is persistent and irreversible.
6. Inflation is caused by excess demand in relation to supply of all types of goods and services.
7. Inflation is a purely monetary phenomenon.
8. Inflation is a post full employment phenomenon.
9. Inflation is a long-term process.

Topic 4-Types of Inflation

Types of Inflation on Rising Prices

Types of inflation on the basis of rising prices or rate of inflation:-

1. **Creeping Inflation** : When prices are gently rising, it is referred as Creeping Inflation. It is the mildest form of inflation and also known as a **Mild** Inflation or **Low** Inflation. According to **R.P. Kent**, when prices rise by not more than (upto) 3% per annum (year), it is called Creeping Inflation.
2. **Chronic Inflation** : If creeping inflation persist (continues to increase) for a longer period of time then it is often called as Chronic or **Secular** Inflation. Chronic Creeping Inflation can be either Continuous (which remains consistent without any downward movement) or Intermittent (which occurs at regular intervals). It is called chronic because if an inflation rate continues to grow for a longer period without any downturn, then it possibly leads to Hyperinflation.
3. **Walking Inflation** : When the rate of rising prices is more than the Creeping Inflation, it is known as Walking Inflation. When prices rise by more than 3% but less than 10% per annum (i.e between 3% and 10% per annum), it is called as Walking Inflation. According to some economists, walking inflation must be taken seriously as it gives a cautionary signal for the occurrence of Running inflation. Furthermore, if walking inflation is not checked in due time it can eventually result in Galloping inflation.
4. **Moderate Inflation** : Prof. Samuelson clubbed together concept of Crepping and Walking inflation into Moderate Inflation. When prices rise by less than 10% per annum (single digit inflation rate), it is known as Moderate Inflation. According to Prof. **Samuelson**, it is a stable inflation and not a serious economic problem.
5. **Running Inflation** : A rapid acceleration in the rate of rising prices is referred as Running Inflation. When prices rise by more than 10% per annum, running inflation occurs. Though economists have not suggested a fixed range for measuring running inflation, we may consider price rise between 10% to 20% per annum (double digit inflation rate) as a running inflation.
6. **Galloping Inflation** : According to Prof. Samuelson, if prices rise by double or triple digit inflation rates like 30% or 400% or 999% per annum, then the situation can be termed as Galloping Inflation. When prices rise by more than 20% but less than 1000% per annum (i.e. between 20% to 1000% per annum), galloping inflation occurs. It is also referred as **Jumping** inflation. India has been witnessing galloping inflation since the second five year plan period.
7. **Hyperinflation** : Hyperinflation refers to a situation where the prices rise at an alarming high rate. The prices rise so fast that it becomes very difficult to measure its magnitude. However, in quantitative terms, when prices rise above 1000% per annum (quadruple or four digit inflation rate), it is termed as Hyperinflation. During a worst case scenario of hyperinflation, value of national currency (money) of an affected country reduces almost to zero. Paper money becomes worthless

and people start trading either in gold and silver or sometimes even use the old barter system of commerce. Two worst examples of hyperinflation recorded in world history are of those experienced by **Hungary** in year 1946 and **Zimbabwe** during 2004-2009 under **Robert Mugabe**'s regime.

Types of Inflation on Causes

Types of inflation on the basis of different causes:-

1. **Deficit Inflation** : Deficit inflation takes place due to deficit financing.
2. **Credit Inflation** : Credit inflation takes place due to excessive bank credit or money supply in the economy.
3. **Scarcity Inflation** : Scarcity inflation occurs due to hoarding. Hoarding is an excess accumulation of basic commodities by unscrupulous traders and black marketers. It is practised to create an artificial shortage of essential goods like food grains, kerosene, etc. with an intension to sell them only at higher prices to make huge profits during scarcity inflation. Though hoarding is an unfair trade practice and a punishable criminal offence still some crooked merchants often get themselves engaged in it.
4. **Profit Inflation** : When entrepreneurs are interested in boosting their profit margins, prices rise.
5. **Pricing Power Inflation** : It is often referred as **Administered Price** inflation. It occurs when industries and business houses increase the price of their goods and services with an objective to boost their profit margins. It does not occur during a financial crisis and economic depression, and is not seen when there is a downturn in the economy. As Oligopolies have the ability to set prices of their goods and services it is also called as **Oligopolistic** Inflation.
6. **Tax Inflation** : Due to rise in indirect taxes, sellers charge high price to the consumers.
7. **Wage Inflation** : If the rise in wages in not accompanied by a rise in output, prices rise.
8. **Build-In Inflation** : Vicious cycle of Build-in inflation is induced by adaptive expectations of workers or employees who try to keep their wages or salaries high in anticipation of inflation. Employers and Organisations raise the prices of their respective goods and services in anticipation of the workers or employees' demands. This overall builds a vicious cycle of rising wages followed by an increase in general prices of commodities. This cycle, if continues, keeps on accumulating inflation at each round turn and thereby results into what is called as Build-in inflation.
9. **Development Inflation** : During the process of development of economy, incomes increases, causing an increase in demand and rise in prices.
10. **Fiscal Inflation** : It occurs due to excess government expenditure or spending when there is a budget deficit.
11. **Population Inflation** : Prices rise due to a rapid increase in population.
12. **Foreign Trade Induced Inflation** : It is divided into two categories, viz., (a) Export-Boom Inflation, and (b) Import Price-Hike Inflation.
13. **Export-Boom Inflation** : Considerable increase in exports may cause a shortage at home (within exporting country) and results in price rise (within exporting country). This is known as Export-Boom Inflation.
14. **Import Price-Hike Inflation** : If a country imports goods from a foreign country, and the prices of imported goods increases due to inflation abroad, then the prices of domestic products using imported goods also rises. This is known as Import Price-Hike Inflation. For e.g. India imports oil from Iran at $100 per barrel. Oil prices in the international market suddenly increases to $150 per barrel. Now India to continue its oil imports from Iran has to pay $50 more per barrel to get the same amount of crude oil. When the imported expensive oil reaches India, the indian consumers also have to pay more and bear the economic burden. Manufacturing and transportation costs also increase due to hike in oil prices. This, consequently, results in a rise in the prices of domestic goods being manufactured and transported. It is the end-consumer in India, who finally pays and experiences the ultimate pinch of Import Price-Hike Inflation. If the oil prices in the international market fall down then the import price-hike inflation also slows down, and vice-versa.

15. **Sectoral Inflation** : It occurs when there is a rise in the prices of goods and services produced by certain sector of the industries. For instance, if prices of crude oil increases then it will also affect all other sectors (like aviation, road transportation, etc.) which are directly related to the oil industry. For e.g. If oil prices are hiked, air ticket fares and road transportation cost will increase.
16. **Demand-Pull Inflation** : Inflation which arises due to various factors like rising income, exploding population, etc., leads to aggregate demand and exceeds aggregate supply, and tends to raise prices of goods and services. This is known as Demand-Pull or **Excess Demand** Inflation.
17. **Cost-Push Inflation** : When prices rise due to growing cost of production of goods and services, it is known as Cost-Push (Supply-side) Inflation. For e.g. If wages of workers are raised then the unit cost of production also increases. As a result, the prices of end-products or end-services being produced and supplied are consequently hiked.

Types of Inflation on Expectation

Types of inflation on the basis of expectation or predictability:-

1. **Anticipated Inflation** : If the rate of inflation corresponds to what the majority of people are expecting or predicting, then is called Anticipated Inflation. It is also referred as **Expected** Inflation.
2. **Unanticipated Inflation** : If the rate of inflation corresponds to what the majority of people are not expecting or predicting, then is called Unanticipated Inflation. It is also referred as **Unexpected** Inflation.

Topic 4-Causes & Types of Inflation

Main Causes of Inflation

1) Cost Push Inflation

Cost-push inflation occurs when businesses respond to rising **production costs**, by raising prices in order to maintain their profit margins. Higher costs shift a firms supply curve upwards and lead to an increase in price. There are many reasons why costs might rise:

- **Rising imported raw materials costs** perhaps caused by inflation in countries that are heavily dependent on exports of these commodities or alternative by a fall in the value of the Rs in the foreign exchange markets which increases the price of imported inputs
- **Rising labour costs** - caused by wage increases which exceed any improvement in productivity. This cause is important in those industries, which are labour-intensive. If labour costs amount for example to 25% of a firms total costs then a 10% increase in the total wage bill will cause the firms total costs to rise by 2.5%.
- **Higher indirect taxes imposed by the government** for example a rise in the specific duty on alcohol and cigarettes, an increase in fuel duties or perhaps a rise in the standard rate of Value Added Tax or an extension to the range of products to which VAT is applied. These taxes are levied on producers who, depending on the price elasticity of demand and supply for their products can opt to pass on the burden of the tax onto consumers. For example, if the government was to choose to levy a new tax on aviation fuel, then this would contribute to a rise in cost-push inflation.

2) Demand Pull Inflation

Demand-pull inflation is likely when there is full employment of resources and short run aggregate supply is inelastic. In these circumstances an increase in AD will lead to a general increase in prices. AD might rise for a number of reasons some of which occur together at the same moment of the economic cycle

- **A depreciation of the exchange rate,** which increases the price of imports and reduces the foreign price of UK exports. If consumers buy fewer imports, while foreigners buy more exports, Aggregate demand will rise. If the economy is already at full employment, prices are pulled upwards.
- **A reduction in direct or indirect taxation**. If direct taxes are reduced consumers have more disposable income causing demand to rise. A reduction in indirect taxes will mean that a given amount of income will now buy a greater real volume of goods and services. Both factors can take aggregate demand and real GDP higher and beyond potential GDP.

- **The rapid growth of the money supply** perhaps as a consequence of increased bank and building society borrowing if interest rates are low and consumer confidence is high. Monetarist economists believe that the root causes of inflation are monetary in particular when the monetary authorities permit an excessive growth of the supply of money in circulation beyond that needed to finance the volume of transactions produced in the economy.
- **Rising consumer confidence and an increase in the rate of growth of house prices** both of which would lead to an increase in total household demand for goods and services
- **Faster economic growth in other countries** providing a boost to UK exports overseas. Remember that export sales provide an extra flow of income and spending into the UK circular flow. Exports are counted as an injection of AD.

Effects of Inflation

1. **Impact of Inflation on Savers:** When inflation is high, people may lose confidence in money as the real value of savings is severely reduced. Savers will lose out if interest rates are lower than inflation – leading to negative real interest rates. This has certainly happened in the UK during 2009-2011.
2. **Inflation Expectations and Wage Demands:** Price increases lead to higher **wage demands** as people try to maintain their real living standards. This process is known as a 'wage-price spiral'.
3. **Arbitrary Re-Distributions of Income:** Inflation tends to hurt people in jobs with **poor bargaining positions** in the labour market - for example people in low paid jobs with little or no trade union protection may see the real value of their pay fall. Inflation can also favour borrowers at the expense of savers as inflation erodes the real value of existing debts.
4. **Business Planning and Investment:** Inflation can disrupt business planning. Budgeting becomes difficult because of the uncertainty created by rising inflation of both prices and costs - and this may reduce planned investment spending.
5. **Competitiveness and Unemployment:** Inflation is a possible cause of higher unemployment in the medium term if one country experiences a much higher rate of inflation than another, leading to a **loss of international competitiveness** and a subsequent worsening of their trade performance.

Benefits of inflation

1. **Higher revenues and profits**: A low stable rate of inflation of say between 1% and 3% allows businesses to raise their prices, revenues and profits, whilst at the same time workers can expect to see an increase in their pay packers. This can give psychological boost and might lead to rising investment and productivity.
2. **Tax revenues**: The government gains from inflation through what is called '**fiscal drag effects'**. For example many indirect taxes are ad valorem in nature, e.g. VAT at 20% - so as prices rise, so does the amount of tax revenue flowing into the Treasury.
3. **Cutting the real value of debt**: Low stable inflation is also a way of helping to reduce the real value of outstanding debts – there are many home owners with huge mortgages who might benefit from a period of inflation to bring down the real burden of their mortgage loans. The government too might welcome a period of higher inflation given the huge level of public sector debt!
4. **Avoiding deflation**: Perhaps one of the key benefits of positive inflation is that an economy can manage to avoid some of the dangers of a deflationary recession

Topic 5- measures to control Inflation

The various methods to control inflation are given below however the most common ones are Monetary and Fiscal Policies:

1. Monetary Policy

With growth of 3.8%, demand in the economy could be growing faster than capacity can grow to meet it. This leads to inflationary pressures. We can term this demand pull inflation. Therefore, reducing the growth of Aggregate demand, should reduce inflationary pressures.

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Monetary policy is the policy of the central bank of the country, which is the supreme monetary and banking authority in a country. The central bank may use such methods as the bank rate, open market operations, the reserve ratio and selective controls in order to control the credit creation operation of commercial banks and thus restrict the amounts of bank deposits in the country. This is known as tight money policy. Monetary policy to control inflation is based on the assumption that a rise in prices is due to a larger demand for goods and services, which is the direct result of expansion of bank credit. To the extent this is true, the central bank's policy will be successful.

Monetary policy may not be effective in controlling inflation, if inflation is due to cost-push factors. Monetary policy can only be helpful in controlling inflation due to demand-pull factors.

Let us see how increasing the rate can help control inflation

A higher interest rate should also lead to higher exchange rate, which helps to reduce inflationary pressure by

- Making imports cheaper.
- Reducing demand for exports and
- Increasing incentive for exporters to cut costs.

2. Fiscal Policy

It is the policy of a government with regard to taxation, expenditure and public borrowing. It has a very important influence on business and economic activity. Taxes determine the size or the volume of disposable income in the hands of the public. The proper tax policy to control inflation will avoid tax cuts, introduce new taxes and raise the rates of existing taxes. The purpose being to reduce the volume of purchasing power in the hands of the public and thus reduces their demand. A precisely similar effect will be achieved if voluntary or compulsory savings are increased. Savings will reduce current demand for goods and thus reduce the inflationary rise in prices.

As an anti-inflationary measure, government expenditure should be reduced. This indicates that demand for goods and services will be further reduced. This policy of increasing public revenue through taxation and decreasing public expenditure is known as surplus budgeting. However, there is one important difficulty is this policy. It may be easy to increase revenue in times of inflation when people have more money income, but difficult to reduce public expenditure.

During war times as well as during a period of development, it is absolutely impossible to reduce the planned expenditure. If the government has already taken up a scheme or a group of schemes, it is ruinous to give them up in the middle. Therefore, public expenditure cannot be used as an anti-inflationary measure. Lastly, public debt, i.e., the debt of the government may be managed in such a way that the supply of money in the country may be controlled.

The government should avoid paying back any of its previous loans during inflation so as to prevent an increase in the circulation of money. Moreover, if the government manages to get a surplus budget, it should be used to cancel public debt held by the central bank. The result will be anti-inflationary since money taken from the public and commercial banks is being cancelled out and is removed from circulation. But the problem is how to get a budget surplus, which is extremely difficult.

3. Price Control and Rationing

This is the most important and effective method available during war and other critical times particularly because both monetary and fiscal policies are more or less useless during this period. Price control implies the establishment to legal upper limits beyond which prices of particular goods should not rise. The purpose of rationing, on the other hand, is to distribute the goods in short supply in an equitable manner among all people, irrespective of their wealth and social status. Price control and rationing generally go together. The chief objection behind use of this method to fight inflation is that they restrict the freedom of the consumers and thus limit their welfare. Besides, its success depends on administrative efficiency, which in many underdeveloped countries is very low.

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4. Other Methods

Another important anti-inflationary device is to increase the supply of goods through either increased production or imports. Production may be increased by shifting factors of production from the production of less inflation sensitive goods, which are in comparative abundance to the production of those goods which are in short supply and which are inflation-sensitive. Moreover, shortage of goods internally may be relieved through imports of inflation sensitive goods, either on credit or in exchange for export of luxury goods and other non-essentials.

5. Realistic Methods

1. Increase the supply of goods and services: When the supply of goods and services is increased, the prices will come down.
2. Population planning: Control on population by adopting different measures of family planning will reduce the demand and finally prices will be controlled.
3. Price control policy: The govt. should adopt strict price control policy against the profiteers and hoarders.
4. Economic Planning: Effective economic planning is necessary to control the inflation in the country.

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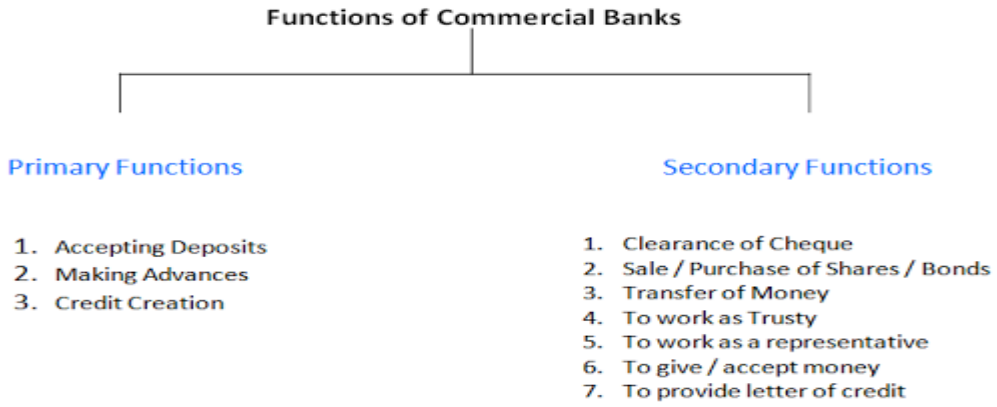
Unit 5
Banking, stock market & insurance

Topic 1: Definition & Functions of commercial banks

Definitions of Commercial Bank:

1) According to **Prof. Sayers**, "A bank is an institution whose debts are widely accepted in settlement of other people's debts to each other." In this definition Sayers has emphasized the transactions from debts which are raised by a financial institution.
2) According to the Indian **Banking Company Act 1949**, "A banking company means any company which transacts the business of banking . Banking means accepting for the purpose of lending of investment of deposits of money from the public, payable on demand or other wise and withdraw able by cheque, draft or otherwise."
3) **Crowther,**" A commercial bank collects money from those who have it to spare or who are saving it out of their income and lends this money to those who require it."

   It is clear that commercial banks act as a **bridge between the users** of capital (investors) and those who save (savers). They activate the idle resources of the community and use them for productive purposes.



Primary / Banking Functions :-

Commercial banks have two important banking functions. One is accepting deposits and other is advancing loans.

1) Deposits :-

One of the main function of a bank is to accept deposits from the public. Deposits are accepted by the banks in various forms.

a) Current Account Deposits :-

Current Accounts are usually opened by businessmen who have a number of regular transactions with the bank, both deposits and withdrawls. There is no restriction on number and amount of deposits. There is also no restriction on withdrawls. No interest is paid on current deposits. Banks may even charge interest for providing this facility. These accounts are also known as demand deposits as amount can be withdrawn on demand.

b) Saving Account Deposits :-

Saving Accounts are opened by salaried and other less income people. There is no restriction on number and amount of deposits. withdrawls are subject to certain restrictions. It earns Interest but less than fixed deposits. It encourages saving habit among salary earners and others. Saving deposits are an important source of funds for banks.

c) Fixed Account Deposits :-

Deposits in fixed account are time deposits. Money under this account is deposited for a certain fixed period of time varying from 15 days to several years. A high rate of interest is paid. If money is withdrawn before expiry date, the depositor receives lower rate of interest. Deposits can be renewed for further period. Many banks sanction loans against security of fixed deposits.

d) Recurring Account Deposits :-

In Recurring deposit, a specified amount is regularly deposited by account holder, at an internal of usually a month. This is to form the habit of small savings among the people. At the end of maturity period, the account holder gets a substantial amount. Interest on this type of deposit is almost equal to fixed deposits.

Thus by creating variety of deposits, banks motivate people in a variety of ways and encourage savings in the economy.

2) Loans And Advances :-

Banks not only mobilize money but also lend to its credit worthy customers for maximizing profits. Loans and Advances are granted To :-

a) Business And Trade :-

Commercial banks grant short-term loans to business and trade activities in following forms:-

i) Overdraft :-

Commercial banks grant overdraft facility to current account holders Under this system a borrower is allowed to draw more than what is deposited in his account. The borrower is granted to a fixed additional amount against collateral security. Interest is charged for actual amount drawn.

ii) Cash Credit :-

Cash credit is given by the bank to any businessman to meet regular working capital needs, against the security of goods or personal security. Interest is charged on actual amount drawn by the customer.

iii) Discounting Of Bills :-

When the holder of the bill is not in a position to wait till the maturity of the bill and requires cash urgently, he sells the bill of exchange to bank. Bank advance credit by discounting bills of exchange, government securities or any other approved financial instruments. The bank purchases the instruments at a discount.

iv) Money At Call :-

Banks also grant loans for a very short period, generally not exceeding 7 days. Such advances are repayable immediately at a short notice hence they are called as Money at Call or Call money. These loans are given to dealers or brokers in stock market against Collateral Securities.

v) Direct Loans :-

Loans are given to customers against the security of moveable properties. Their maturity varies from 1 to 10 years. Interest has to be paid on entire loan amount sanctioned. Loans are of many types like :- personal loans, term loans, call loans, participative loans, collateral loans etc.

b) Loans to Agriculture :-

Banks grant short-term credit to agriculture at a lower rate of interest. Loans are granted for irrigation, purchase of equipments, inputs, cattle etc.

c) Loans To Industries :-

Banks grant secured loans to small and medium scale industries to meet their working capital needs. The time period may be from one to five years. It may be in the form of Overdraft, cash credit or direct loan.

d) Loans To Foreign Trade :-

Loans are granted to export and import in the form of direct loans, discounting of bills, guarantee for deferred payments etc. Here the rate of interest is low.

e) Consumer Credit / Personal loans :-

Banks also grant credit to household in a limited amount to buy some durable consumer goods like television sets, refrigerators, washing machine etc. Such consumer credit is repayable in installments. Under 20-point programme, the scope of consumer credit has been extended to cover expenses on marriage, funeral etc., as well.

f) Miscellaneous Advances :-

Banks also gives advances like packing credits to exporters, export bill purchased or discounted, import finance, finance to self-employed, credit to weaker sections of society at concessional rates etc.

II. Secondary / Non-banking Functions :-

Banks gives various forms of services to public. Such services are termed as non- banking or secondary functions:-

1. Agency Services:-

Banks perform certain functions on behalf of their customers. While performing these services, banks act as agents to their customers, hence these are called as agency services. Important agency functions are :-

a) Collection :-

Commercial banks collect cheques, drafts, bills, promissory notes, dividends, subscriptions, rents and any other receipts which are to be received by the customer. For these services banks charge a nominal amount.

b) payment :-

Banks also makes payments on behalf of their customers like paying insurance premium, rent, taxes, electricity and telephone bills etc for such services commission is charged.

c) Income – Tax Consultant :-

Commercial banks acts as income-tax consultants. They prepare and finalise the income tax returns of their clients.

d) Sale And Purchase Of Financial Assets :-

As per the customers instruction banks undertake sale and purchase of securities, shares and any other financial assets. Nominal charges are charged by a bank.

e) Trustee, Executor And Attorney :-

As a trustee, banks becomes the custodian and manager of customer funds. Bank also acts as executor of deceased customer's will. As an Attorney the banks sign the documents on behalf of customer.

f) E- Banking :-

Through Electronic Banking, a customer can operate his bank account through internet. He can make payments of various bills. He can even transfer money from one place to another.

2. Utility Services :-

Modern Commercial banks also performs certain general utility services for the community, such as :-

a) Letter Of Credit :-

Banks also deal in foreign trade. They issue letter of credit and provide guarantee to foreign traders for the soundness of their customers.

b) Transfer Of Funds :-

Banks arrange transfer of funds cheaply and safely from one place to another. Transfer can be in the form of Demand draft, Mail transfer Travellers cheques etc.

c) Guarantor :-

Banks offer a guarantee of payment on behalf of importer to facilitate imports with deferred payments.

d) Underwriting :-

This facility is provided to Joint Stock Companies and to government to enable them to raise funds.

Banks guarantee the purchase of certain proportion of shares, if not sold in the market.

e) Locker Facility :-

Safe Lockers are provided to the customers. So that they can deposit their valuables like Jewellary, Securities, Shares and otherdocuments.

f) Referee :-

Banks may act as referee with respect to financial standing, business reputation and respectability of customers.

g) Credit Cards :-

Credit card facility have been introduced by commercial banks. It enables the holder to minimize the use of hard cash. Credit card is a convenient medium of exchange which enables its holder to buy goods and services from member – establishment without using money.

III. Subsidiary Activities :-

Many commercial banks also undertakes subsidiary activities such as :-

1) Housing Finance :-

Housing finance is provided against the security of immoveable property of land and buildings. Many banks such as SBI, Bank of India etc. have set up housing finance subsidiaries.

2) Mutual Funds :-

A Mutual fund is a financial intermediary that pools the savings of investors for collective investment in diversified portfolio securities Many banks like SBI, Indian Bank etc. have set up mutual fund subsidiaries.

3) Merchant Banking :-

A variety of services are offered by merchant banking like :-
Management, Marketing and Underwriting of new issues, project promotion, corporate advisory services, investment advisory services etc.

4) Venture Capital Fund :-

Venture capital fund provides start-up share capital to new ventures of little known, unregistered, risky, young and small private business, especially in technology oriented and knowledge intensive business. Many commercial banks like SBI, Canara Bank etc. have set up venture Capital Fund Subsidiaries.

5) Factoring:-

Factoring is a continuing arrangement between a financial intermediary (factor) and a business concern (client) where by the factor purchases the clients accounts recieveable. Banks like SBI and Canara Bank have established subsidiaries to provide factoring services.

Thus various services are provided by commercial Banks.

Topic 2 : The process of credit creation

Creation of credit is an important function of a commercial bank. Prof. Sayers said "Banks are not merely purveyors of money but, also in an important sense manufacturers of money". In a modern economy Bank's deposits form a major proportion of total money supply.

A bank's demand deposits arise mainly from :- Cash deposits by customers and Bank Loans and Investments.

1. Cash Deposits By Customers:-

These are termed as primary deposits as they arise from the actual deposits of cash in a bank made by its customers. In receiving such deposits, the bank plays a passive role. The creation of primary deposits, however is nothing but transforming the currency money in to deposit money.

2. Bank Loans And Investments :-

These are termed as derivative or active deposits. The derivative deposits are lent in the form of loans

or advances, discounting of bills or used for purchasing securities or other assets.
Deposit account in the name of the customer or seller, credits him with the amount of loan granted or value of security purchased, subject to withdrawal by cheque, as required. Hence loans advanced or purchases of securities creates deposits.
Thus every loan creates a deposit. They increase the quantity of bank money. The size of derivative demand deposits is determined by the banks lending and investment activities. There will be a constant inflow and outflow of cash with the banks. For the sake of liquidity and safety some proportion of total deposit must be maintained in cash, for e.g. :- 10% to 20% to meet the demand for cash at the counter. This is known as Cash Reserve Ratio.
Primary deposits serve as a basis for creating derivative deposits, that is credit creation, and for increasing money supply. Commercial banks are profit seeking institutions and when they find that large volume of cash received lies Idle, they use these resources for advancing loans or for making investment in securities, shares etc. there by earning high rate of interest. The creation of credit also depends on excess cash reserves or cash reserve ratio. The derivative deposits are used as working capital.
When the borrower withdraws money from his loan account by cheque it is deposited by the payee in some other bank. Those banks again create deposit on the basis of fresh deposits received after keeping required reserves. Ultimately, the total volume of credit or derivative deposits or bank money created by all banks would be a multiple of the original amount of new cash reserves in the system. Thus multiple expansion of credit takes place.

Example of Credit creation: The process of money creation can be explained by taking an example of a bank XYZ. A depositor deposits Rs.10,000 in his savings account, which will become the demand deposit of the bank. Based on the assumption that not all customers will turn up at the same day to withdraw their deposits, bank maintains a minimum cash reserve of 10 % of the demand deposits, i.e. Rs.1000. It lends the remaining amount of Rs.9000 in the form of credit to other customers. This further creates deposits for the bank XYZ. With the cash reserve of Rs.1000, the credit creation is worth Rs.10,000. So, the credit multiplier is given by:
Credit multiplier = 1/CRR = 1/10% = 10

The money supply in the economy will increase by the amount (times) of credit multiplier

Topic 3: Process of NBFC's

What is NBFC: NBFC means Non-banking financial company. A non-banking financial company (NBFC) is a company registered under the Companies Act, 1956 of India and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business, but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.

Definition under the RBI Act
Section 45I of the Reserve Bank of Indi a Act, 1934 defines ''non-banking financial company'' as–
(i) A financial institution which is a company;
(ii) A non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
(iii) Such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.

Type of Services provided by NBFCs:

NBFCs provide range of financial services to their clients. Types of services under non-banking finance services include the following:

1) **Hire Purchase Services :** Hire purchase the legal term for a conditional sale contract with an intention to finance consumers towards vehicles, white goods etc. If a buyer cannot afford to pay the price as a lump sum but can afford to pay a percentage as a deposit, the contract allows the buyer to hire the goods for a monthly rent. If the buyer defaults in paying the installments, the owner can repossess the goods. HP is a different form of credit system among other unsecured consumer credit systems and benefits. Hero Honda Motor Finance Co., Bajaj Auto Finance Company is some of the HP financing companies.
2) **Leasing Services :** A lease or tenancy is a contract that transfers the right to possess specific property. Leasing service includes the leasing of assets to other companies either on operating lease or finance lease. An NBFC may obtain license to commence leasing services subject to , they shall not hold, deal or trade in real estate business and shall not fix the period of lease for less than 3 years in the case of any finance lease agreement except in case of computers and other IT accessories. First Century Leasing Company Ltd., Sundaram Finance Ltd. is some of the Leasing companies in India.
3) **Housing Finance Services :** Housing Finance Services means financial services related to development and construction of residential and commercial properties. An Housing Finance Company approved by the National Housing Bank may undertake the services /activities such as Providing long term finance for the purpose of constructing, purchasing or renovating any property, Managing public or private sector projects in the housing and urban development sector and Financing against existing property by way of mortgage. ICICI Home Finance Ltd., LIC Housing Finance Co. Ltd., HDFC is some of the housing finance companies in our country.
4) **Asset Management Company :** Asset Management Company is managing and investing the pooled funds of retail investors in securities in line with the stated investment objectives and provides more diversification, liquidity, and professional management service to the individual investors. Mutual Funds are comes under this category. Most of the financial institutions having their subsidiaries as Asset Management Company like SBI, BOB, UTI and many others.
5) **Venture Capital Companies :** Venture capital Finance is a unique form of financing activity that is undertaken on the belief of high-risk-high-return. Venture capitalists invest in those risky projects or companies (ventures) that have success potential and could promise sufficient return to justify such gamble. Venture capitalist not only provides finance but also often provides managerial or technical expertise to venture projects. In India, venture capital concentrate on seed capital finance for high technology and for research & development. ICICI ventures and Gujarat Venture are one of the first venture capital organizations in India and SIDBI, IDBI and others also promoting venture capital finance activities.
6) **Mutual Benefit Finance Companies (MBFC's),:** A mutual fund is a financial intermediary that allows a group of investors to pool their money together with a predetermined investment objective. The mutual fund will have a fund manager who is responsible for investing the pooled money into specific securities/bonds. Mutual funds are one of the best investments ever created because they are very cost efficient and very easy to invest in. By pooling money together in a mutual fund, investors can purchase stocks or bonds with much lower trading costs than if they tried to do it on their own. But the biggest advantage to mutual funds is diversification.

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Unit 6
Concept of SEBI & Stock market

Topic 1- Meaning, functions & Importance of stock market

CONCEPT OF SEBI

Securities Exchange Board of India (SEBI) was set up in 1988 to regulate the functions of securities market. SEBI promotes orderly and healthy development in the stock market but initially SEBI was not able to exercise complete control over the stock market transactions. It was left as a watch dog to observe the activities but was found ineffective in regulating and controlling them. As a result in May 1992, SEBI was granted legal status. SEBI is a body corporate having a separate legal existence and perpetual succession.

Reasons for Establishment of SEBI:

With the growth in the dealings of stock markets, lot of malpractices also started in stock markets such as price rigging, 'unofficial premium on new issue, and delay in delivery of shares, violation of rules and regulations of stock exchange and listing requirements. Due to these malpractices the customers started losing confidence and faith in the stock exchange. So government of India decided to set up an agency or regulatory body known as Securities Exchange Board of India (SEBI).

Purpose and Role of SEBI:

SEBI was set up with the main purpose of keeping a check on malpractices and protect the interest of investors. It was set up to meet the needs of three groups.

1. Issuers:

For issuers it provides a market place in which they can raise finance fairly and easily.

2. Investors:

For investors it provides protection and supply of accurate and correct information.

3. Intermediaries:

For intermediaries it provides a competitive professional market.

Objectives of SEBI:

The overall objectives of SEBI are to protect the interest of investors and to promote the development of stock exchange and to regulate the activities of stock market. The objectives of SEBI are:

1. To regulate the activities of stock exchange.
2. To protect the rights of investors and ensuring safety to their investment.
3. To prevent fraudulent and malpractices by having balance between self regulation of business and its statutory regulations.
4. To regulate and develop a code of conduct for intermediaries such as brokers, underwriters, etc.

Functions of SEBI:

The SEBI performs functions to meet its objectives.

1. Protective Functions:

These functions are performed by SEBI to protect the interest of investor and provide safety of investment.

As protective functions SEBI performs following functions:

(i) It Checks Price Rigging:

Price rigging refers to manipulating the prices of securities with the main objective of inflating or depressing the market price of securities. SEBI prohibits such practice because this can defraud and cheat the investors.

(ii) It Prohibits Insider trading:

Insider is any person connected with the company such as directors, promoters etc. These insiders have sensitive information which affects the prices of the securities. This information is not available to people at large but the insiders get this privileged information by working inside the company and if they use this

information to make profit, then it is known as insider trading, e.g., the directors of a company may know that company will issue Bonus shares to its shareholders at the end of year and they purchase shares from market to make profit with bonus issue. This is known as insider trading. SEBI keeps a strict check when insiders are buying securities of the company and takes strict action on insider trading.

(iii) SEBI prohibits fraudulent and Unfair Trade Practices:

SEBI does not allow the companies to make misleading statements which are likely to induce the sale or purchase of securities by any other person.

(iv) SEBI undertakes steps to educate investors so that they are able to evaluate the securities of various companies and select the most profitable securities.

(v) SEBI promotes fair practices and code of conduct in security market by taking following steps:

(a) SEBI has issued guidelines to protect the interest of debenture-holders wherein companies cannot change terms in midterm.

(b) SEBI is empowered to investigate cases of insider trading and has provisions for stiff fine and imprisonment.

(c) SEBI has stopped the practice of making preferential allotment of shares unrelated to market prices.

2. Developmental Functions:

These functions are performed by the SEBI to promote and develop activities in stock exchange and increase the business in stock exchange. Under developmental categories following functions are performed by SEBI:

(i) SEBI promotes training of intermediaries of the securities market.

(ii) SEBI tries to promote activities of stock exchange by adopting flexible and adoptable approach in following way:

(a) SEBI has permitted internet trading through registered stock brokers.

(b) SEBI has made underwriting optional to reduce the cost of issue.

(c) Even initial public offer of primary market is permitted through stock exchange.

3. Regulatory Functions:

These functions are performed by SEBI to regulate the business in stock exchange. To regulate the activities of stock exchange following functions are performed:

(i) SEBI has framed rules and regulations and a code of conduct to regulate the intermediaries such as merchant bankers, brokers, underwriters, etc.

(ii) These intermediaries have been brought under the regulatory purview and private placement has been made more restrictive.

(iii) SEBI registers and regulates the working of stock brokers, sub-brokers, share transfer agents, trustees, merchant bankers and all those who are associated with stock exchange in any manner.

(iv) SEBI registers and regulates the working of mutual funds etc.

(v) SEBI regulates takeover of the companies.

(vi) SEBI conducts inquiries and audit of stock exchanges.

The Organisational Structure of SEBI:

1. SEBI is working as a corporate sector.
2. Its activities are divided into five departments. Each department is headed by an executive director.
3. The head office of SEBI is in Mumbai and it has branch office in Kolkata, Chennai and Delhi.
4. SEBI has formed two advisory committees to deal with primary and secondary markets.
5. These committees consist of market players, investors associations and eminent persons.

Objectives of the two Committees are:

1. To advise SEBI to regulate intermediaries.
2. To advise SEBI on issue of securities in primary market.
3. To advise SEBI on disclosure requirements of companies.

4. To advise for changes in legal framework and to make stock exchange more transparent.
5. To advise on matters related to regulation and development of secondary stock exchange.

These committees can only advise SEBI but they cannot force SEBI to take action on their advice.

MEANING, FUNCTION & IMPORTANCE OF STOCK MARKETS,PRIMARY & SECONDARY MARKETS

Introduction : Stock Exchange (also called *Stock Market* or *Share Market*) is one important constituent of capital market. Stock Exchange is an organized market for the purchase and sale of industrial and financial security. It is convenient place where trading in securities is conducted in systematic manner i.e. as per certain rules and regulations. It performs various functions and offers useful services to investors and borrowing companies. It is an investment intermediary and facilitates economic and industrial development of a country.

Definitions of Stock Exchange

According to **Husband and Dockerary**,

"Stock exchanges are privately organized markets which are used to facilitate trading in securities."

The Indian Securities Contracts (Regulation) Act of 1956, defines Stock Exchange as,

"An association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities."

Characteristics or features of stock exchange

1. **Market for securities** : Stock exchange is a market, where securities of corporate bodies, government and semi-government bodies are bought and sold.
2. **Deals in second hand securities** : It deals with shares, debentures bonds and such securities already issued by the companies. In short it deals with existing or second hand securities and hence it is called secondary market.
3. **Regulates trade in securities** : Stock exchange does not buy or sell any securities on its own account. It merely provides the necessary infrastructure and facilities for trade in securities to its members and brokers who trade in securities. It regulates the trade activities so as to ensure free and fair trade
4. **Allows dealings only in listed securities** : In fact, stock exchanges maintain an official list of securities that could be purchased and sold on its floor. Securities which do not figure in the official list of stock exchange are called unlisted securities. Such unlisted securities cannot be traded in the stock exchange.
5. **Transactions effected only through members** : All the transactions in securities at the stock exchange are affected only through its authorized brokers and members. Outsiders or direct investors are not allowed to enter in the trading circles of the stock exchange. Investors have to buy or sell the securities at the stock exchange through the authorized brokers only.
6. **Association of persons** : A stock exchange is an association of persons or body of individuals which may be registered or unregistered.
7. **Recognition from Central Government** : Stock exchange is an organized market. It requires recognition from the Central Government.
8. **Working as per rules** : Buying and selling transactions in securities at the stock exchange are governed by the rules and regulations of stock exchange as well as **SEBI Guidelines**. No deviation from the rules and guidelines is allowed in any case.
9. **Specific location** : Stock exchange is a particular market place where authorised brokers come together daily (i.e. on working days) on the floor of market called trading circles and conduct trading activities. The prices of different securities traded are shown on electronic boards. After the working hours market is closed. All the working of stock exchanges is conducted and controlled through computers and electronic system.
10. **Financial Barometers** : Stock exchanges are the financial barometers and development indicators of national economy of the country. Industrial growth and stability is reflected in the index of stock exchange.

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Functions of stock market are:

1) **Continuous and ready market for securities:** Stock exchange provides a ready and continuous market for purchase and sale of securities. It provides ready outlet for buying and selling of securities. Stock exchange also acts as an outlet/counter for the sale of listed securities.
2) **Facilitates evaluation of securities:** Stock exchange is useful for the evaluation of industrial securities. This enables investors to know the true worth of their holdings at any time. Comparison of companies in the same industry is possible through stock exchange quotations (i.e price list).
3) **Encourages capital formation:** Stock exchange accelerates the process of capital formation. It creates the habit of saving, investing and risk taking among the investing class and converts their savings into profitable investment. It acts as an instrument of capital formation. In addition, it also acts as a channel for right (safe and profitable) investment.
4) **Provides safety and security in dealings** :Stock exchange provides safety, security and equity (justice) in dealings as transactions are conducted as per well defined rules and regulations. The managing body of the exchange keeps control on the members. Fraudulent practices are also checked effectively. Due to various rules and regulations, stock exchange functions as the custodian of funds of genuine investors
5) **Regulates company management:** Listed companies have to comply with rules and regulations of concerned stock exchange and work under the vigilance (i.e supervision) of stock exchange authorities.
6) **Facilitates public borrowing:** Stock exchange serves as a platform for marketing Government securities. It enables government to raise public debt easily and quickly.
7) **Provides clearing house facility:** Stock exchange provides a clearing house facility to members. It settles the transactions among the members quickly and with ease. The members have to pay or receive only the net dues (balance amounts) because of the clearing house facility.
8) **Facilitates healthy speculation** : Healthy speculation, keeps the exchange active. Normal speculation is not dangerous but provides more business to the exchange. However, excessive speculation is undesirable as it is dangerous to investors & the growth of corporate sector.
9) **Serves as Economic Barometer :** Stock exchange indicates the state of health of companies and the national economy. It acts as a barometer of the economic situation / conditions.
10) **Facilitates Bank Lending**: Banks easily know the prices of quoted securities. They offer loans to customers against corporate securities. This gives convenience to the owners of securities.

Secondary Market

- The secondary market is that part of the capital market that deals with the securities that are already issued in the primary market.
- The investors who purchase the newly issued securities in the primary market sell them in the secondary market. The secondary market needs to be transparent and highly liquid in nature as it deals with the already issued securities. In the secondary market, the value of a particular stock also varies from that of the face value. The resale value of the securities in the secondary market is dependant on the fluctuating interest rates.
- Securities issued by a company for the first time are offered to the public in the primary market. Once the IPO is done and the stock is listed, they are traded in the secondary market. The main difference between the two is that in the primary market, an investor gets securities directly from the company through IPOs, while in the secondary market, one purchases securities from other investors willing to sell the same.
- Equity shares, bonds, preference shares, treasury bills, debentures, etc. are some of the key products available in a secondary market. SEBI is the regulator of the same.

Difference between Primary Market and Secondary Market

- Primary and Secondary markets refer to markets which assist corporations obtain capital funding. The difference between these two markets lies in the process that is used to collect funds.

- The Primary market refers to the market where new securities are issued by the company that wishes to obtain capital and is sold directly to the investor
- The secondary market refers to the market where securities that have already been issued are traded. Instruments that are usually traded on the secondary market include stocks, bonds, options and futures
- The main difference is that, in the primary market, the company is directly involved in the transaction, whereas in the secondary market, the company has no involvement since the transactions occur between investors.

Topic 2- Concepts of Shares & debentures

- **SHARE** : In financial markets, a **share** is a unit of account for various investments. It often means the stock of a corporation, but is also used for collective investments such as mutual funds, limited partnerships, and real estate investment trusts. A corporation divides its capital into shares, which are offered for sale to raise capital, termed as issuing shares. Thus, a share is an indivisible unit of capital, expressing the contractual relationship between the company and the shareholder. The denominated value of a share is its face value: the total capital of a company is divided into a number of shares.

- **DEBENTURE: A debenture** is a document that either creates a debt or acknowledges it, and it is a debt without collateral. In corporate finance, the term is used for a medium- to long-term debt instrument used by large companies to borrow money. In some countries the term is used interchangeably with **bond**, **loan stock** or **note**. A debenture is thus like a certificate of loan or a loan bond evidencing the fact that the company is liable to pay a specified amount with interest and although the money raised by the debentures becomes a part of the company's capital structure, it does not become share capital. Senior debentures get paid before subordinate debentures, and there are varying rates of risk and payoff for these categories. Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in the company's general meetings of shareholders, but they may have separate meetings or votes e.g. on changes to the rights attached to the debentures. The interes`t paid to them is a charge against profit in the company's financial statements

- **DIFFERENCE BETWEEN SHARES & DEBENTURES**
  The major differences between debentures and shares (1) Rights the Debentures constitute loan and only a creditor of the company. The shares represents a part of the share capital of the capital. (2) Approval in debentures question of getting approval for payment of interest does not arise. In shares, Dividend is payable only when it is recommended by the Board and approved by the general meeting of the shareholders. (3) Liability in the debentures is not having such liability. In share sholder's liability is limited to the unpaid amount of the shares. (4) Return of Capital in debentures are redeemable either at a fixed date or at the option of the company during the lifetime itself. In shares are non-repayable during the lifetime of the company except in the case of redeemable preference shares. (5) Charge on Assets in the Debentures are generally secured and shares have no charge on the assets of the company.

Topic 3- Insurance & its Types

Insurance is the equitable transfer of the risk of a loss, from one entity to another in exchange for payment. It is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss. There are the following categories of risk

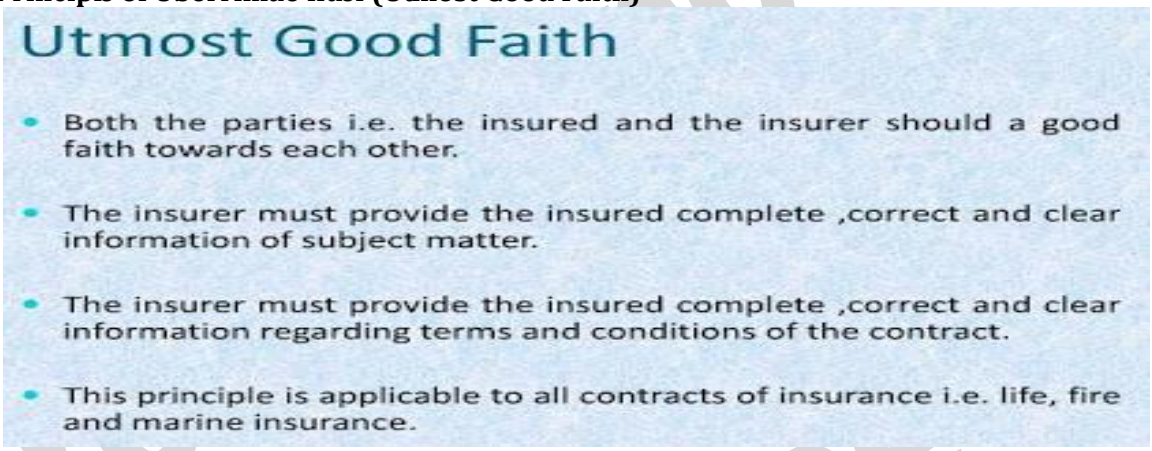
1. Financial risks which means that the risk must have financial measurement.
2. Pure risks which means that the risk must be real and not related to gambling
3. Particular risks which means that these risks are not widespread in their effect, for example such as earthquake risk for the region prone to it.

It is commonly accepted that only financial, pure and particular risks are insurable. An insurer, or insurance carrier, is a company selling the insurance; the insured, or policyholder, is the person or entity buying the

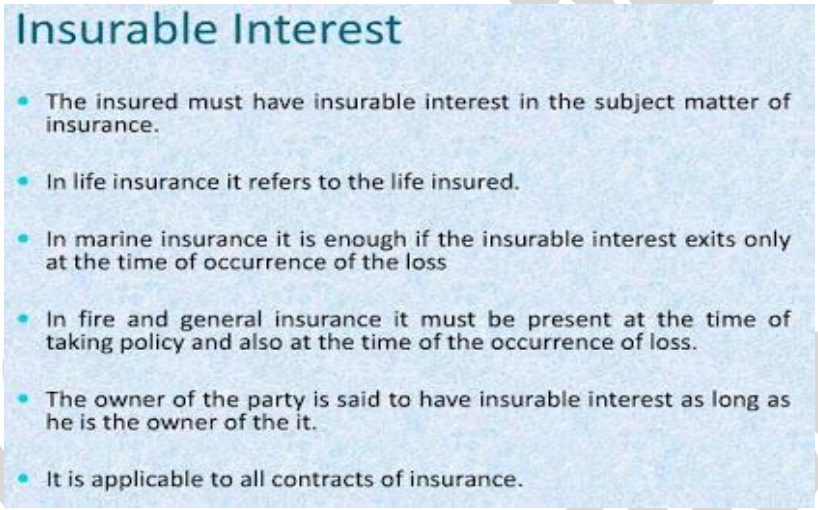
insurance policy. The amount of money to be charged for a certain amount of insurance coverage is called the premium.

7 Basic principles of insurance

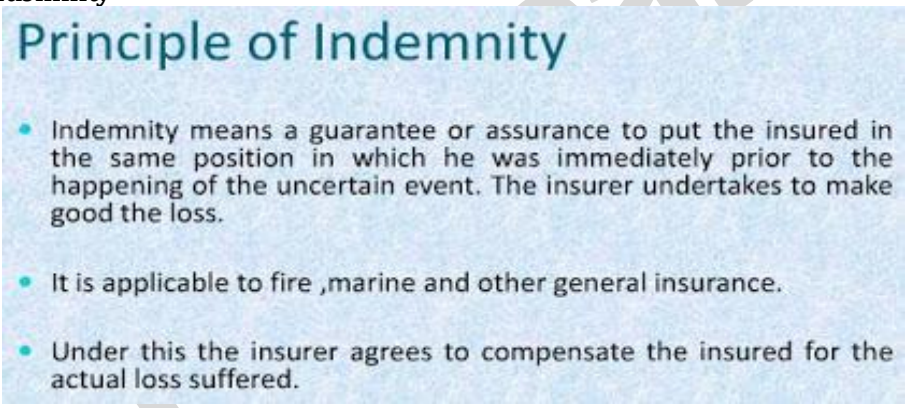
1) Principle of Uberrimae fidei (Utmost Good Faith)



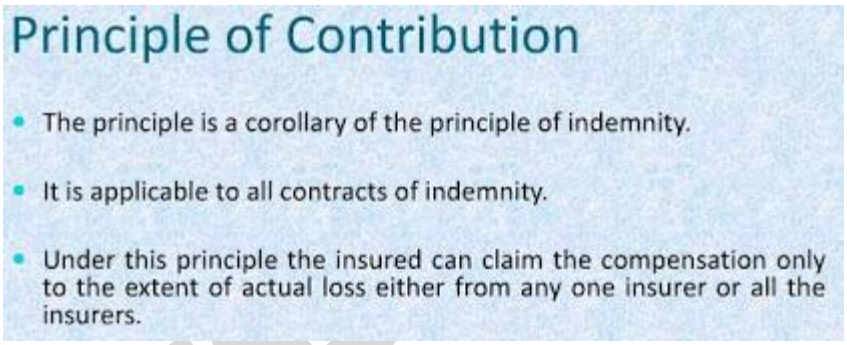
2) Principle of Insurable Interest



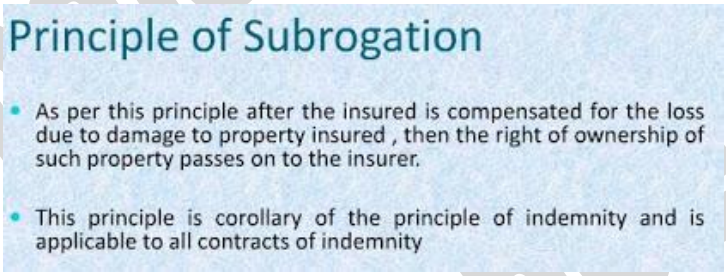
3) Principle of Indemnity



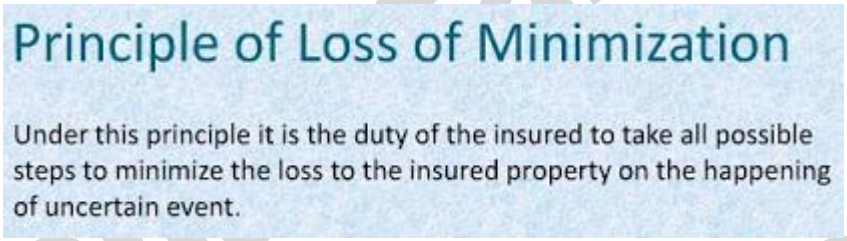
4) Principle of Contribution



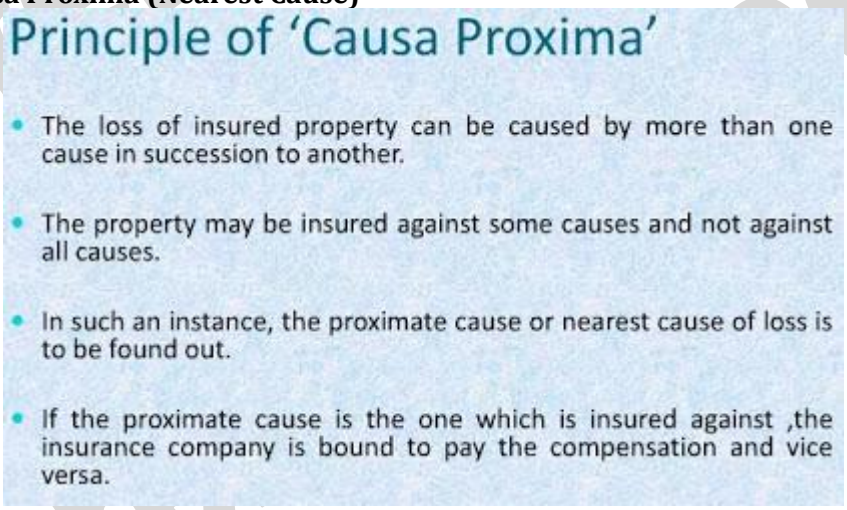
5) Principle of Subrogation

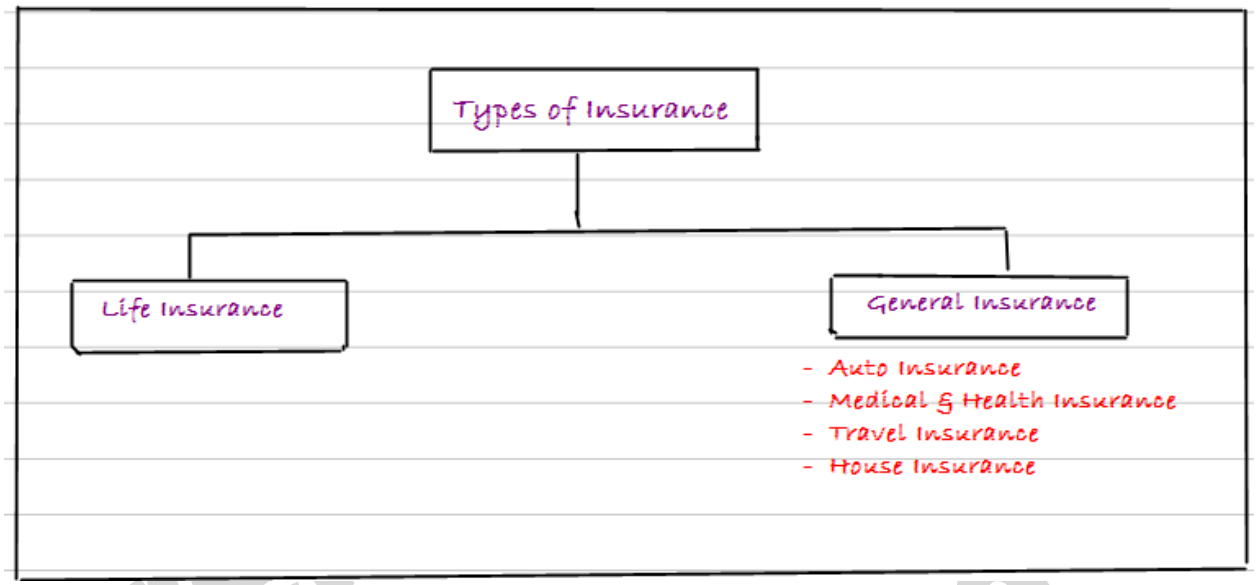


6) Principle of Loss Minimization



7) Principle of Causa Proxima (Nearest Cause)





LIFE INSURANCE : Life insurance (or commonly life assurance, especially in the Commonwealth) is a contract between an insured (insurance policy holder) and an insurer or assurer, where the insurer promises to pay a designated beneficiary a sum of money (the "benefits") in exchange for a premium, upon the death of the insured person. Depending on the contract, other events such as terminal illness or critical illness may also trigger payment. The policy holder typically pays a premium, either regularly or as a lump sum. Other expenses (such as funeral expenses) are also sometimes included in the benefits.
Life policies are legal contracts and the terms of the contract describe the limitations of the insured events. Specific exclusions are often written into the contract to limit the liability of the insurer; common examples are claims relating to suicide, fraud, war, riot, and civil commotion.
Life-based contracts tend to fall into two major categories:

- Protection policies – designed to provide a benefit in the event of specified event, typically a lump sum payment. A common form of this design is term insurance.
- Investment policies – where the main objective is to facilitate the growth of capital by regular or single premiums. Common forms (in the US) are whole life, universal life, and variable life policies.

GENERAL INSURANCE :General insurance or non-life insurance policies, including automobile and homeowners policies, provide payments depending on the loss from a particular financial event. General insurance typically comprises any insurance that is not determined to be life insurance. It is called property and casualty insurance in the U.S. and Canada and Non-Life Insurance in Continental Europe.

DIFFERENCE BETWEEN LIFE INSURANCE & GENERAL INSURANCE

Type of contract

Life insurance is a non-personal insurance contract. This means that the policyholder and the person being insured do not have to be the same person. General insurance is always a personal contract where the insurance company contracts with you directly for insurance protection.

Function

Both life insurance and general insurance accept premiums in exchange for insurance benefits. Insurance premiums are invested into bonds or bond-like investments that produce stable and consistent returns for the insurance company. The investments, plus premium payments, also ensure that the insurance company can pay the promised benefits that are outlined in the insurance policy. When you need to file a claim, both

types of insurance require a claim form for you to fill out. The payment of benefits, and the amount of the benefit that is payable, are always spelled out in your insurance contract.

Significance

Life insurance insures your life or the life of someone that you have an economic interest in, like your spouse, children, siblings or business partners. When the insured individual dies, the life insurance policy pays a death benefit that is fixed. This is called a valued contract. A valued contract pays a fixed sum of money, regardless of the nature of the loss insured by the contract.

General insurance insures homes, automobiles and other personal property. This type of insurance is sometimes referred to as "property and casualty" insurance. General insurance is indemnity insurance. Indemnity insurance pays just enough money to you to repair or replaced the insured property. For example, your homeowner's insurance may cover your entire home and the contents of it. However, if your roof is damaged in a storm, the policy only pays enough to repair the damage.

Benefits

The benefit of life insurance is that it pays off any financial obligations you have left after you die. It can pay more than that, however, because life insurance pays a fixed amount. Death benefits can be used to create wealth for the surviving beneficiaries, or they can be used to replace the primary income earner's salary for a surviving spouse.

General insurance is beneficial in that the insurance ensures that, almost regardless of the damage done, that the property will be repaired or replaced. While general insurance generally has a maximum payout determined by the value of your property, it does not pay a fixed amount, so you won't have to guess at how much insurance you need to purchase.

Topic 4- Functions of RBI

Functions of Reserve Bank of India

1. Bank of Issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government. The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes. The assets and liabilities of the Issue Department are kept separate from those of the Banking Department. Originally, the assets of the Issue Department were to consist of not less than two-fifths of gold coin, gold bullion or sterling securities provided the amount of gold was not less than Rs. 40 crores in value. The **remaining three-fifths of the assets** might be held in rupee coins, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India. Due to the exigencies of the Second World War and the post-was period, these provisions were considerably modified. Since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Ra. 200 crores, of which at least Rs. 115 crores should be in gold. The system as it exists today is known as the minimum reserve system.

2. Banker to Government

The second important function of the Reserve Bank of India is to act as Government banker, agent and adviser. The Reserve Bank is agent of Central Government and of all State Governments in India excepting that of Jammu and Kashmir. The Reserve Bank has the obligation to transact Government business, via. to keep the cash balances as deposits free of interest, to receive and to make payments on behalf of the Government and to carry out their exchange remittances and other banking operations. The Reserve Bank of India helps the Government - both the Union and the States to float new loans and to manage public debt. The Bank makes ways and means advances to the Governments for 90 days. It makes loans and advances to

the States and local authorities. It acts as adviser to the Government on all monetary andbanking matters.

3. Bankers'Bank and Lender of the Last Resort

The Reserve Bank of India acts as the bankers' bank. According to the provisions of the Banking Companies Act of 1949, every scheduled bank was required to maintain with the Reserve Bank a cash balance equivalent to 5% of its demand liabilites and 2 per cent of its time liabilities in India. By an amendment of 1962, the distinction between demand and time liabilities was abolished and banks have been asked to keep cash reserves equal to 3 per cent of their aggregate deposit liabilities. The minimum cash requirements can be changed by the Reserve Bank of India.

The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities or get financial accommodation in times of need or stringency by rediscounting bills of exchange. Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis the Reserve Bank becomes not only the banker's bank but also the lender of the last resort.

4. Controller of Credit

The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank rate or through open market operations. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a licence from the Reserve Bank of India to do banking business within India, the licence can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

As supreme banking authority in the country, the Reserve Bank of India, therefore, has the following powers:
(a) It holds the cash reserves of all the scheduled banks.
(b) It controls the credit operations of banks through quantitative and qualitative controls.
(c) It controls the banking system through the system of licensing, inspection and calling for information.
(d) It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

5. Custodian of Foreign Reserves

The Reserve Bank of India has the responsibility to maintain the official rate of exchange. According to the Reserve Bank of India Act of 1934, the Bank was required to buy and sell at fixed rates any amount of sterling in lots of not less than Rs. 10,000. The rate of exchange fixed was Re. 1 = sh. 6d. Since 1935 the Bank was able to maintain the exchange rate fixed at lsh.6d. though there were periods of extreme pressure in favour of or against the rupee. After India became a member of the International Monetary Fund in 1946, the Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the I.M.F.

Besides maintaining the rate of exchange of the rupee, the Reserve Bank has to act as the custodian of India's reserve of international currencies. The vast sterling balances were acquired and managed by the Bank. Further, the RBI has the responsibility of administering the exchange controls of the country.

6. Supervisory functions

In addition to its traditional central banking functions, the Reserve bank has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction, and liquidation. The RBI is authorised to carry out periodical inspections of the banks and to call for returns and necessary information from them. The nationalisation of 14 major Indian scheduled banks in July 1969 has imposed new responsibilities on the RBI for directing the growth of banking and credit policies towards more rapid development of the economy and realisation of certain desired social objectives. The supervisory functions of the RBI have helped a great deal in improving the standard of banking in India to develop on sound lines and to improve the methods of their operation.

7. Promotional functions

With economic growth assuming a new urgency since Independence, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a varietyof developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialised financing agencies. Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; it set up the Deposit Insurance Corporation in 1962, the Unit Trust of India in 1964, the Industrial Development Bank of India also in 1964, the Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up directly or indirectly by the Reserve Bank to promote saving habit and to mobilise savings, and to provide industrial finance as well as agricultural finance. As far back as 1935, the Reserve Bank of India set up the Agricultural Credit Department to provide agricultural credit. But only since 1951 the Bank's role in this field has become extremely important. The Bank has developed the co-operative credit movement to encourage saving, to eliminate moneylenders from the villages and to route its short term credit to agriculture. The RBI has set up the Agricultural Refinance and Development Corporation to provide long-term finance to farmers.

Topic 5-Methods of credit control- Qualitative & Quantitative Methods

The RBI adopt two methods to control credit in modern times for regulating bank advances. They are as follows:-

(A) Quantitative or General Credit Control

This method aims to regulate the amount of bank advance. This method includes:

(a) Bank Rate
(b) Open Market Operation
(c) Variables Reserves Ratio

(a) Bank Rate: It is the rate at which central bank discounts the securities of commercial banks or advance loans to commercial banks. This rate is the minimum and it affects both cost and availability of credit. Bank rate is different from market rate. Market rate is the rate of discount prevailing in the money market among other lending institutions. Generally bank rate is higher than the market rate. If the bank rate is changed all the other rates normally change at the same direction. A central bank control credit by manipulating the bank rate. If the central bank raise the bank rate to control credit, the market discount rate and other lending rates in the money will go up. The cost of credit goes up and demand for credit goes down. As a result, the volume of bank loans and advances is curtailed. Thus raise in bank rate will contract credit.

(b) Open Market Operation: It refers to buying and selling of Government securities by the central bank in the open market. this method of credit control become very popular after the 1st World War. During inflation, the bank will securities and during depression, it will purchase securities from the public and financial

institutions. The RBI is empowered to buy and sell government securities from the public and financial institutions. The RBI is empowered to buy and sell government securities, treasury bills and other approved securities. The central bank uses the weapon to overcome seasonal stringency in funds during the slack season. When the central bank sells securities, they are purchased by the commercial banks and private individuals. So money supply is reduced in the economy and there is contraction in credit.

When the securities are purchased by the central bank, money goes to the commercial banks and the customers. SO money supply is increased in the economy and there is more demand for credit. Thus open market operation is one of the superior instrument of credit control. But for achieving an ideal result both Bank Rate and Open Market Operation must be used simultaneously.

(c) Variable Reserve Ratio (VRR): This is a new method of credit control adopted by central bank. Commercial banks keep cash reserves with the central bank to maintain for the purpose of liquidity and also to provide the means for credit control. The cash reserve is also called minimum legal reserve requirement. The percentage of this ratio can be changed legally by the central bank. The credit creation of commercial banks depends on the value of cash reserves. If the value of reserve ratio increase and other things remain constant, the power of credit creation by the commercial bank is decreased and vice versa. Thus by varying the reserve ratio, the lending capacity of commercial banks can be affected.

(B) Qualitative or Selective Control Method:
It is also known as **qualitative credit control.** This method is used to control the flow of credit to particular sectors of the economy. The direction of credit is regulated by the central bank. This method is used as a complementary to quantitative credit control discourage the flow of credit to unproductive sectors and speculative activities and also to attain price stability. The main instruments used for this purpose are:

(1) Varying margin requirements for certain bank: While lending commercial banks accept securities, deduct a certain margin from the market value of the security. This margin is fixed by the central bank and adjust according to the requirements. This method affect the demand for credit rather than the quantity and cost of credit. This method is very effective to control supply of credit for speculative dealing in the stock exchange market. It also helps for checking inflation when the margin is raised. If the margin is fixed as 30%, the commercial banks can lend up to 70% of the market value of security. This method has been used by RBI since 1956 with suitable modifications from time to time as per the demand and supply of commodities.

(2) Regulation of consumer's credit: Apart from trade and industry a great amount of credit is given to the consumers for purchasing durable goods also. RBI seeks to control such credit in the following ways:
(a) by regulating the minimum down payments on specific goods.
(b) by fixing the coverage of selective consumers durable goods.
(c) by regulating the maximum maturities on all installment credit and
(d) by fixing exemption costs of installment purchase of specific goods.

(3) Control through Directives: Under this system, the central bank can issue directives for the credit control. There may be a written or oral voluntary agreement between the central bank and commercial banks in this regard. Sometimes the commercial banks do not follow these directives of the RBI.

(4) Rationing of credit: The amount of credit to be granted is fixed by the central bank. Credit is rationed by limiting the amount available to each commercial bank. The RBI can also restrict the discounting of bills. Credit can also be rationed by the fixation of ceiling for loans and advances.

(5) Direct Action: It is an extreme step taken by the RBI. It involves refusal by RBI to extend credit facilities, denial of permission to open new branches etc. RBI also gives wide publicity about the erring banks to create

awareness amongst the public.

(6) Moral suasion: RBI uses persuasion to influence lending activities of banks. It sends letters to banks periodically, advising them to follow sound principles of banking. Discussions are held by the RBI with banks to control the flow of credit to the desired sectors.

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Unit 5: Banking
FUNCTIONS OF COMMERCIAL BANK

Definitions of Commercial Bank:

1. **Crowther,**" A commercial bank collects money from those who have it to spare or who are saving it out of their income and lends this money to those who require it."
2. **Reed and gill,** "a commercial bank is a financial institution that accepts demand deposits and makes commercial loans and is regulated by a bank regulatory agency.:
3. The Indian banking companies act, 1949 (now termed as the banking regulation act, since 1956) lays down that the commercial banking consists in "The accepting for the purpose of lending or investment, deposits of money from the public, repayable on demand or otherwise and withdraw able by cheque, draft, order or other.

Thus, a commercial bank is an institution which accepts deposits from the public in turn advance loans by creating credit.

Features:

1. It is a commercial institution; it aims at earning profit.
2. It deals with money; it accepts deposits and advances loans.
3. It deals with credit; it has ability to create credit.

It is clear that commercial banks act as a **bridge between the users** of capital (investors) and those who save (savers). They activate the idle resources of the community and use them for productive purposes.

Commercial Banks and other Financial Institutions: Commercial Banks are different from other financial institutions (F.I.) from the following point of view:

1. Acceptance of chequable deposits is a necessary, but not sufficient condition for financial institutions (F.I.) to be a bank. For example, post office savings banks are not banks in this sense of the term even though they accept deposits from the public. This is because, they do not perform the other essential function of lending.
2. Leading alone does not make Financial Institution (F.I.) a bank. For example, many FIs like LIC, UTI, and IDBI, etc. lend to others but they are not banks in this sense of the term, is they don not accept chequable deposits.
3. Financial Institutions cannot create credit though they may he accepting deposits and making advances.

CLASSIFICATION OF COMMERCIAL BANKS

Commercial banks can be of two types:
I. Scheduled commercial bank and II. Non-scheduled commercial bank.
There are **three** kinds of the scheduled commercial bank.

(a) Public sector banks.
(b) Private sector banks.
(c) Foreign banks.

Public sector banks can be of two types:
(a) **SBI** and its subsidiaries.
(b) **Other** nationalized banks.
Chart 1. gives the classification of commercial banks.

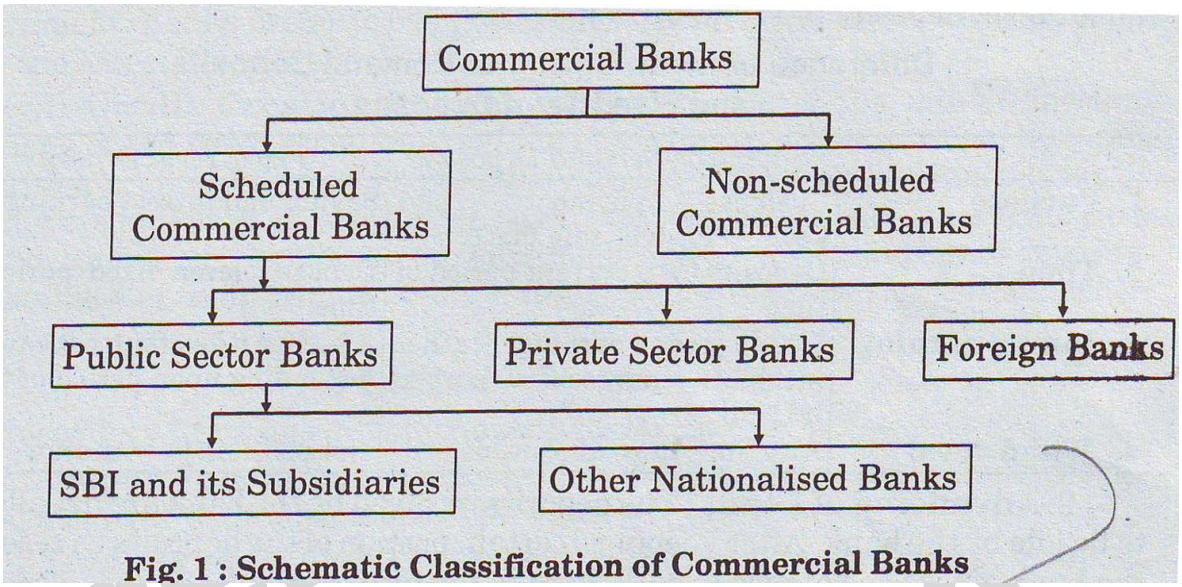

Fig. 1 : Schematic Classification of Commercial Banks

PROCESS OF CREDIT CREATION

Commercial banks occupy a pivotal position in the economic machinery of a country. It is so because they create money. They are not only purveyors of money but also manufacturers of money. They not only trade in money but also product money.

Meaning of credit creation: bank deposits come into existence in two ways: first, when customers deposit legal tender money in the bank, deposits arise. Such bank deposits are known as primary or actual deposits. It is out of these primary deposits, the bank grants loans or credit.

Second, the most important form of deposit arises in the process of granting a loan by the bank, when somebody applies for loan to the bank. After being assured about his creditworthiness, the bank may immediately sanction it to him. But the bank does not make payment immediately in hard cash. When a bank grants a loan, it usually opens as account in the name of the customers and credits the amount of the loan to his account. He is allowed to withdraw money by cheque or otherwise according to his requirements. Thus, whenever loans are granted deposits arise, such deposits are known as 'derivative deposits' because it has been derived from the loan transaction of the bank. The creation of secondary deposits is called the creation of credit.

With a little cash in hand, commercial banks can multiply loans and advance and hence deposits. It is because of their unique multiple credits creating power that the commercial banks are called as 'manufacturers of money' or 'factories of credit'.

WHAT ARE NBFCs?

Non-bank financial companies(NBFCs) are financial institutions that provide banking services without meeting the legal definition of a bank, i.e. one that does not hold a banking license.

NBFCs include a loan company, an investment company, asset finance company (i.e. a company conducting the business of equipment leasing or hire purchase finance) and Residuary Non-Banking Companies. NBFCs are incorporated under the Companies Act, 1956.

NBFCs can be classified into two broad categories, viz.,

(i) NBFCs accepting public deposit (NBFCs-D) and

(ii) NBFCs not accepting/holding public deposit (NBFCs-ND).

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An NBFC must be registered with the Reserve Bank of India (RBI) and have specific authorization to accept deposits from the public.
NBFC must display the Certificate of Registration or a certified copy thereof at the Registered office and other offices/branches.
Registration of an NBFC with the RBI merely authorizes it to conduct the business of NBFC. RBI does not guarantee the repayment of deposits accepted by NBFCs. .NBFCs cannot use the name of the RBI in any manner while conducting their business.
The NBFC whose application for grant of Certificate of Registration (CoR) has been rejected or cancelled by the RBI is neither authorized to accept fresh deposits nor renew existing deposit. Such rejection or cancellation is also published in newspapers from time to time

DIFFERENCE BETWEEN NBFCs AND BANK
NBFCs operate almost like banks, except for running accounts, where money can be easily withdrawn by writing cheques or using a debit card.NBFCs are doing functions akin to that of banks; however there are a few differences:

1. An NBFC cannot accept demand deposits;
2. An NBFC is not a part of the payment and settlement system and as such an NBFC cannot issue cheques drawn on itself; and
3. Deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available for NBFC depositors unlike in case of banks.

TYPES OF NBFC
Originally, NBFCs registered with RBI were classified as:
(i) **Equipment leasing company**:Means any company which is a financial institution carrying on as its principal business,the activity of leasing of equipment or the financing of such activity.
(ii) **Hire-purchase company**- Means any company which is a financial institution carrying on as its principal business hire purchase transactions or the financing of such transactions.

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Unit 6:
Concept of SEBI stock market
CONCEPT OF SHARES & DEBENTURES

SHARE : In financial markets, a **share** is a unit of account for various investments. It often means the stock of a corporation, but is also used for collective investments such as mutual funds, limited partnerships, and real estate investment trusts. A corporation divides its capital into shares, which are offered for sale to raise capital, termed as issuing shares. Thus, a share is an indivisible unit of capital, expressing the contractual relationship between the company and the shareholder. The denominated value of a share is its face value: the total capital of a company is divided into a number of shares.

DEBENTURE: A debenture is a document that either creates a debt or acknowledges it, and it is a debt without collateral. In corporate finance, the term is used for a medium- to long-term debt instrument used by large companies to borrow money. In some countries the term is used interchangeably with **bond**, **loan stock** or **note**. A debenture is thus like a certificate of loan or a loan bond evidencing the fact that the company is liable to pay a specified amount with interest and although the money raised by the debentures becomes a part of the company's capital structure, it does not become share capital. Senior debentures get paid before subordinate debentures, and there are varying rates of risk and payoff for these categories. Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in the company's general meetings of shareholders, but they may have separate meetings or votes e.g. on changes to the rights attached to the debentures. The interes`t paid to them is a charge against profit in the company's financial statements

DIFFERENCE BETWEEN SHARES & DEBENTURES

The major differences between debentures and shares (1) Rights the Debentures constitute loan and only a creditor of the company. The shares represents a part of the share capital of the capital. (2) Approval in debentures question of getting approval for payment of interest does not arise. In shares, Dividend is payable only when it is recommended by the Board and approved by the general meeting of the shareholders. (3) Liability in the debentures is not having such liability. In share sholder's liability is limited to the unpaid amount of the shares. (4) Return of Capital in debentures are redeemable either at a fixed date or at the option of the company during the lifetime itself. In shares are non-repayable during the lifetime of the company except in the case of redeemable preference shares. (5) Charge on Assets in the Debentures are generally secured and shares have no charge on the assets of the company.

Functions of Reserve Bank of India

1. Bank of Issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government. The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes. The assets and liabilities of the Issue Department are kept separate from those of the Banking Department. Originally, the assets of the Issue Department were to consist of not less than two-fifths of gold coin, gold bullion or sterling securities provided the amount of gold was not less than Rs. 40 crores in value. The **remaining three-fifths of the assets** might be held in rupee coins, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India. Due to the exigencies of the Second World War and the post-was period, these provisions were considerably modified. Since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Ra. 200 crores, of which at least Rs. 115 crores should be in gold. The system as it exists today is known as the minimum reserve system.

2. Banker to Government

The second important function of the Reserve Bank of India is to act as Government banker, agent and adviser. The Reserve Bank is agent of Central Government and of all State Governments in India excepting that of Jammu and Kashmir. The Reserve Bank has the obligation to transact Government business, via. to keep the cash balances as deposits free of interest, to receive and to make payments on behalf of the Government and to carry out their exchange remittances and other banking operations. The Reserve Bank of India helps the Government - both the Union and the States to float new loans and to manage public debt. The Bank makes ways and means advances to the Governments for 90 days. It makes loans and advances to the States and local authorities. It acts as adviser to the Government on all monetary andbanking matters.

3. Bankers'Bank and Lender of the Last Resort

The Reserve Bank of India acts as the bankers' bank. According to the provisions of the Banking Companies Act of 1949, every scheduled bank was required to maintain with the Reserve Bank a cash balance equivalent to 5% of its demand liabilites and 2 per cent of its time liabilities in India. By an amendment of 1962, the distinction between demand and time liabilities was abolished and banks have been asked to keep cash reserves equal to 3 per cent of their aggregate deposit liabilities. The minimum cash requirements can be changed by the Reserve Bank of India.

The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities or get financial accommodation in times of need or stringency by rediscounting bills of exchange. Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis the Reserve Bank becomes not only the banker's bank but also the lender of the last resort.

4.Controller-of-Credit

The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank rate or through open market operations. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a licence from the Reserve Bank of India to do banking business within India, the licence can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

As supreme banking authority in the country, the Reserve Bank of India, therefore, has the following powers:
(a) It holds the cash reserves of all the scheduled banks.
(b) It controls the credit operations of banks through quantitative and qualitative controls.
(c) It controls the banking system through the system of licensing, inspection and calling for information.
(d) It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

5.Custodian-of-Foreign-Reserves

The Reserve Bank of India has the responsibility to maintain the official rate of exchange. According to the Reserve Bank of India Act of 1934, the Bank was required to buy and sell at fixed rates any amount of sterling in lots of not less than Rs. 10,000. The rate of exchange fixed was Re. 1 = sh. 6d. Since 1935 the Bank was able to maintain the exchange rate fixed at lsh.6d. though there were periods of extreme pressure in favour of or against the rupee. After India became a member of the International Monetary Fund in 1946, the

Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the I.M.F.

Besides maintaining the rate of exchange of the rupee, the Reserve Bank has to act as the custodian of India's reserve of international currencies. The vast sterling balances were acquired and managed by the Bank. Further, the RBI has the responsibility of administering the exchange controls of the country.

6.Supervisory-functions

In addition to its traditional central banking functions, the Reserve bank has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction, and liquidation. The RBI is authorised to carry out periodical inspections of the banks and to call for returns and necessary information from them. The nationalisation of 14 major Indian scheduled banks in July 1969 has imposed new responsibilities on the RBI for directing the growth of banking and credit policies towards more rapid development of the economy and realisation of certain desired social objectives. The supervisory functions of the RBI have helped a great deal in improving the standard of banking in India to develop on sound lines and to improve the methods of their operation.

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METHODS OF CREDIT CONTROL- QUALITATIVE & QUANTITATIVE METHODS

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Stock exchange

What is Stock Exchange? Meaning

1. Stock Exchange (also called Stock Market or Share Market) is one important constituent of capital market. Stock Exchange is an organized market for the purchase and sale of industrial and financial security. It is convenient place where trading in securities is conducted in systematic manner i.e. as per certain rules and regulations.

It performs various functions and offers useful services to investors and borrowing companies. It is an investment intermediary and facilitates economic and industrial development of a country.

2. Stock exchange is an organized market for buying and selling corporate and other securities. Here, securities are purchased and sold out as per certain well-defined rules and regulations. It provides a convenient and secured mechanism or platform for transactions in different securities. Such securities include shares and debentures issued by public companies which are duly listed at the stock exchange, and bonds and debentures issued by government, public corporations and municipal and port trust bodies. Stock exchanges are indispensable for the smooth and orderly functioning of corporate sector in a free market economy. A stock exchange need not be treated as a place for speculation or a gambling den. It should act as a place for safe and profitable investment, for this, effective control on the working of stock exchange is necessary. This will avoid misuse of this platform for excessive speculation, scams and other undesirable and anti-social activities.

3. London stock exchange (LSE) is the oldest stock exchange in the world. While Bombay stock exchange (BSE) is the oldest in India. Similar Stock exchanges exist and operate in large majority of countries of the world.

Definitions of Stock Exchange

1. According to Husband and Dockerary,

"Stock exchanges are privately organized markets which are used to facilitate trading in securities."

2. The Indian Securities Contracts (Regulation) Act of 1956, defines Stock Exchange as, "An association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities."

Features of Stock Exchange

Characteristics or features of stock exchange are:-

1. Market for securities : Stock exchange is a market, where securities of corporate bodies, government and semi-government bodies are bought and sold.

2. Deals in second hand securities : It deals with shares, debentures bonds and such securities already issued by the companies. In short it deals with existing or second hand securities and hence it is called secondary market.

3. Regulates trade in securities : Stock exchange does not buy or sell any securities on its own account. It merely provides the necessary infrastructure and facilities for trade in securities to its members and brokers who trade in securities. It regulates the trade activities so as to ensure free and fair trade

4. Allows dealings only in listed securities : In fact, stock exchanges maintain an official list of securities that could be purchased and sold on its floor. Securities which do not figure in the official list of stock exchange are

called unlisted securities. Such unlisted securities cannot be traded in the stock exchange.

5. Transactions effected only through members : All the transactions in securities at the stock exchange are effected only through its authorised brokers and members. Outsiders or direct investors are not allowed to enter in the trading circles of the stock exchange. Investors have to buy or sell the securities at the stock exchange through the authorised brokers only.

6. Association of persons : A stock exchange is an association of persons or body of individuals which may be registered or unregistered.

7. Recognition from Central Government : Stock exchange is an organised market. It requires recognition from the Central Government.

8. Working as per rules : Buying and selling transactions in securities at the stock exchange are governed by the rules and regulations of stock exchange as well as SEBI Guidelines. No deviation from the rules and guidelines is allowed in any case.

9. Specific location : Stock exchange is a particular market place where authorised brokers come together daily (i.e. on working days) on the floor of market called trading circles and conduct trading activities. The prices of different securities traded are shown on electronic boards. After the working hours market is closed. All the working of stock exchanges is conducted and controlled through computers and electronic system.

10. Financial Barometers : Stock exchanges are the financial barometers and development indicators of national economy of the country. Industrial growth and stability is reflected in the index of stock exchange.

Primary & secondary markets

The main components of capital market are: 1. Primary Market 2. Secondary Market

1. Primary Market (New Issue Market): Primary market is also known as new issue market. As in this market securities are sold for the first time, i.e., new securities are issued from the company. Primary capital market directly contributes in capital formation because in primary market company goes directly to investors and utilises these funds for investment in buildings, plants, machinery etc.The primary market does not include finance in the form of loan from financial institutions because when loan is issued from financial institution it implies converting private capital into public capital and this process of converting private capital into public capital is called going public. The common securities issued in primary market are equity shares, debentures, bonds, preference shares and other innovative securities.

Method of Floatation of Securities in Primary Market:

The securities may be issued in primary market by the following methods:

1. Public Issue through Prospectus:

Under this method company issues a prospectus to inform and attract general public. In prospectus company provides details about the purpose for which funds are being raised, past financial performance of the company, background and future prospects of company.

The information in the prospectus helps the public to know about the risk and earning potential of the company and accordingly they decide whether to invest or not in that company Through IPO company can approach large number of persons and can approach public at large. Sometimes companies involve intermediaries such as bankers, brokers and underwriters to raise capital from general public.

2. Offer for Sale:

Under this method new securities are offered to general public but not directly by the company but by an

intermediary who buys whole lot of securities from the company. Generally the intermediaries are the firms of brokers. So sale of securities takes place in two steps: first when the company issues securities to the intermediary at face value and second when intermediaries issue securities to general public at higher price to earn profit. Under this method company is saved from the formalities and complexities of issuing securities directly to public.

3. Private Placement:
Under this method the securities are sold by the company to an intermediary at a fixed price and in second step intermediaries sell these securities not to general public but to selected clients at higher price. The issuing company issues prospectus to give details about its objectives, future prospects so that reputed clients prefer to buy the security from intermediary. Under this method the intermediaries issue securities to selected clients such as UTI, LIC, General Insurance, etc.

The private placement method is a cost saving method as company is saved from the expenses of underwriter fees, manager fees, agents' commission, listing of company's name in stock exchange etc. Small and new companies prefer private placement as they cannot afford to raise from public issue.

4. Right Issue (For Existing Companies):
This is the issue of new shares to existing shareholders. It is called right issue because it is the pre-emptive right of shareholders that company must offer them the new issue before subscribing to outsiders. Each shareholder has the right to subscribe to the new shares in the proportion of shares he already holds. A right issue is mandatory for companies under Companies' Act 1956.

The stock exchange does not allow the existing companies to go for new issue without giving pre-emptive rights to existing shareholders because if new issue is directly issued to new subscribers then the existing equity shareholders may lose their share in capital and control of company i.e., it would water their equity. To stop this the pre-emptive or right issue is compulsory for existing company.

5. e-IPOs, (electronic Initial Public Offer):
It is the new method of issuing securities through on line system of stock exchange. In this company has to appoint registered brokers for the purpose of accepting applications and placing orders. The company issuing security has to apply for listing of its securities on any exchange other than the exchange it has offered its securities earlier. The manager coordinates the activities through various intermediaries connected with the issue.

2. Secondary Market (Stock Exchange):
1.. The secondary market is the market for the sale and purchase of previously issued or second hand securities.

2. In secondary market securities are not directly issued by the company to investors. The securities are sold by existing investors to other investors. Sometimes the investor is in need of cash and another investor wants to buy the shares of the company as he could not get directly from company. Then both the investors can meet in secondary market and exchange securities for cash through intermediary called broker.

3. In secondary market companies get no additional capital as securities are bought and sold between investors only so directly there is no capital formation but secondary market indirectly contributes in capital formation by providing liquidity to securities of the company.

4. If there is no secondary market then investors could get back their investment only after redemption period is over or when company gets dissolved which means investment will be blocked for a long period of

time but with the presence of secondary market, the investors can convert their securities into cash whenever they want and it also gives chance to investors to make profit as securities are bought and sold at market price which is generally more than the original price of the securities.

5. This liquidity offered by secondary market encourages even those investors to invest in securities who want to invest for small period of time as there is option of selling securities at their convenience.

Types of insurance

Sad eventualities such as loss of income, death, sickness, accidents, damage to property and many more are difficult to accurately predict. But thanks to insurance, you can cover possible unfortunate events so that when they happen you can conveniently restore status quo. Below is a list of common types of insurance:

Life Insurance – Pays out a specified figure to the insured or specified beneficiaries on a specific event such as death of the insured. [More: Types of Life Insurance]

Personal Accident Insurance – This will compensate you if at any single time an external violent event causes you disability, injury or death.

Medical and Health Insurance – You'll need it to ascertain continued flow of income if you fall sick or get injured to the extent that you can't work and earn as before. It also covers cost of medication, hospitalization and surgery. [More: Types of Health Insurance]

Vehicle Insurance – If you own a car, motor cycle or any other motor vehicle, this insurance covers it against accident or theft. A compressive package covers all possible losses as well as damages to third parties such as pedestrians.

Home Insurance – Take this cover to insure your home against loss or damage as a result of fire, electricity fault, plumping malfunction, flood, etc.

Travel Insurance – When travelling alone or with your family, this cover ensures you're compensated for any loss, damage, injury, sickness or inconvenience that comes up as a result. It may cover personal accidents, hijackings, travel delays and more.

Portable Electronic Device Insurance – This covers portable devices such as cell phones, laptops or tablets. The cover ensures replacement or repair of such devices if they're stolen, lost or damaged.

Crime Insurance – This covers you or your business against loss or damage as a result of criminal acts of third parties. Covered risks include loss of funds through embezzlement by employees.

Workers Compensation – An employer takes this policy on behalf of their employees to cover loss of income or medical expenses resulting from a work-related injury or sickness.

Disability Overhead Insurance – This is a cover against overhead expenses for business owners who are unable to work.

Aviation Insurance – This covers aircraft operations against aviation risks. Specific policies will offer compensation for damaged aircraft as well as cover third party liabilities such as injured or killed passengers, damaged crops or property etc.

Crop Insurance – If you're a farmer, the cover protects you from losses associated with crop failure as a

result of bad weather, infection or infestation.

Life insurance

Very simply a life insurance is an agreement between two parties where one is insurer and the other is insuree. Life insurance agreement is also called Life Assurance. Purpose of life insurance is to provide security to the family of insuree. Every person have some plans for its family and future for which he struggles and earns money, but if the person is the only financial support of his family there can be a great trouble for his family in case of his earlier death. Therefore, to avoid this life risk insurance companies provide financial security to the specific person holding agreement. In return, of agreement the person has to pay some specific amount or installments until his death or last date of installments written in the agreement. In case the person does not die during this period and fulfills all installments, he is eligible to be paid by the insurance company. The company is now bound to pay him the amount that was written in agreement and had to be paid on his death. Life insurance is just like a gambling because there is high risk for the company who is insuring the agreement, because nobody knows that who will live for how many years. This is another reason of attraction for criminals or fraudulent people to deceive the company. However companies have made some of strong policies to avoid these frauds.

Importance of life insurance

As discussed above that life insurance is very necessary for safer future of one's family, it has become compulsory in most of nations to have life insurance policy. Most of employers have implied contract of life insurance under an employment contract. Following are some beneficial areas of life insurance:

1. Earlier Death: It provides financial support to the family of the person who had insurance policy and died earlier. The family is paid a fixed whole sum amount by the company.
2. Old age Help: In case the person does not die and is grown older, obviously he would have completed all installments, he will get the whole sum amount of insurance agreement which will definitely help him in his olg age life where people are unable to do stressful jobs.
3. Credit Security: Sometimes the insurance policy can be given as a loan security to improve your credit rating in front of lender and to get loans for businesses or other purposes.
4. Tax exemptions: Under the tax Act there is a rule which allows the insurance installment to be exempted from tax.
5. Safe Savings: It is somehow a tool of safe spending of one's savings because he is bound by the agreement to pay insurance installments regularly, which in return discourages the person to waste his money in useless things. And after the completion of all installments he is rewarded for his patience in form of a huge and handsome amount.

General insurance

1. General insurance or non-life insurance policies, including automobile and homeowners policies, provide payments depending on the loss from a particular financial event. General insurance is typically defined as any insurance that is not determined to be life insurance. It is called property and casualty insurance in the U.S. and Canada and Non-Life Insurance in Continental Europe.

2. Insurance other than 'Life Insurance' falls under the category of General Insurance. General Insurance comprises of insurance of property against fire, burglary etc, personal insurance such as Accident and Health Insurance, and liability insurance which covers legal liabilities. There are also other covers such as Errors and Omissions insurance for professionals, credit insurance etc.

3. Non-life insurance companies have products that cover property against Fire and allied perils, flood storm and inundation, earthquake and so on. There are products that cover property against burglary, theft etc. The non-life companies also offer policies covering machinery against breakdown,there are policies that cover

the hull of ships and so on. A Marine Cargo policy covers goods in transit including by sea, air and road. Further, insurance of motor vehicles against damages and theft forms a major chunk of non-life insurance business.

4. Suitable general Insurance covers are necessary for every family. It is important to protect one's property, which one might have acquired from one's hard earned income. A loss or damage to one's property can leave one shattered. Losses created by catastrophes such as the tsunami, earthquakes, cyclones etc have left many homeless and penniless. Such losses can be devastating but insurance could help mitigate them. Property can be covered, so also the people against Personal Accident. A Health Insurance policy can provide financial relief to a person undergoing medical treatment whether due to a disease or an injury.

5. Most general insurance covers are annual contracts. However, there are few products that are long-term.