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**PRINCIPLES  
OF  
MONEY AND BANKING**

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**BY**

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**WITH A FOREWORD**

**BY**

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**To**  
**MY DEAR MOTHER**

## PREFACE

There are already a large number of good books on the subject of money and banking, but most of them are either very advanced or too elementary. My only excuse, therefore, for adding this small treatise to the vast store of knowledge already existing on the subject is to prepare a handy manual which could meet the needs of the average student.

With this end in view, I have throughout endeavoured to present the matter in a simple, lucid and comprehensive form, at the same time making it as concise as possible.

I have fully covered the requirements of the intermediate standard and can say that the book will also be useful to students preparing for the B. A. and B. Com. examinations. I must not hesitate to mention that this has often necessitated reference to several books.

One pleasant duty remains, and that is to acknowledge my indebtedness to Prof. B.N. Chatterji, M.A., B.L., Dean, Faculty of Commerce, Lucknow University, who has very kindly read this work in manuscript and made several valuable suggestions.

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N. K. KATIHA

## FOREWORD

The problems of Currency, Exchange and Banking are so vast and complex that to write a comprehensive book on the subject demands not only powers of literary presentation but a critical and analytical study of the history and developments of Currency and Banking in India and the leading countries of the world. In view of the interest which is being evinced in this country in the study of these problems, a number of new books bearing on the subject have been published in recent years, most of which unfortunately fail to conform to the needs of those for whom they are intended. Though the existing literature on the subject is fairly large, I have always felt the need for a really good book written in an attractive style and a simple non-technical language which will be intelligible to the serious student and the lay reader alike. I, therefore, welcome Mr. N. K. Katiha's book, *Principles of Money and Banking* which in my opinion is undoubtedly an improvement on most of the existing books on the subject. Mr. Katiha's presentation of facts is at once interesting and illuminating, while his suggestions and criticisms are both stimulating and vigorous. I have much pleasure in commending it to the students of Currency and Banking who are sure to profit by the much valuable material contained in the book, to be found only in works of a more ambitious nature.

B. N. CHATTERJI,  
DEAN, FACULTY OF COMMERCE,  
Dec. 10, 1937.                      LUCKNOW UNIVERSITY.

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**PART I**  
**MONEY AND CURRENCY**



## CHAPTER I

### NATURE AND FUNCTIONS OF MONEY

Economic development and monetary progress are correlated and interdependent phenomena. The stage of industrial advancement reached by a society is reflected in the system of exchange adopted and adjusted to the needs of the people. Thus, economic progress is at once a cause as well as an effect of monetary progress.

In the primitive society there was no such thing as money, and all trade took the form of barter, i. e. direct exchange of goods for goods without the intervention of any other medium. When a hunter had a surplus stock of meat which he could not immediately put to any proper use, he readily exchanged it with his neighbour for furs which he needed but which his neighbour had in excess of his requirements.

It is the essence of every exchange including barter that each party to the transaction must gain in utility. One of the essential conditions of barter is that each party must need what the other wants to give. Unless the hunter wants to exchange meat for milk which the herdsman wants to give in return for meat and for nothing else, no

barter is possible. For, if the herdsman wants furs or fruits and not meat, he would not exchange his milk for meat and the hunter would have to search some other person who would take meat for milk.

Another difficulty of barter is that if one of the parties possesses a thing which he cannot subdivide without a loss, he cannot exchange it for an article of small value.

The exchange of services under a system of barter would involve still greater difficulties.

Put briefly, the difficulties of barter are:

- (1) Want of double coincidence of wants and of services,
- (2) Want of sub-division, and
- (3) Want of measure of value.

Even with all these difficulties barter, as a system of exchange, can fit in the requirements of the primitive community, where there is little division of labour and the acts of exchange are few and far between. But for an industrially developed society with its elaborate division of labour, its divers and complicated wants and its numerous articles to be exchanged, the system becomes obsolete and unworkable.

To obviate these difficulties, an intermediate commodity, called money, which could serve as a general medium of exchange for goods and services

and form a standard of measurement and comparison of values of all other commodities, was introduced. The word "money" is derived from the temple of Juno Moneta, the place which the Romans used for their mint.

The use of money is only a step next to barter. While under barter the exchange is direct and comprised in a single operation, under the system of money the act of buying and selling takes the form of a double exchange—a sale followed by a purchase.

Exchange under money becomes indirect and is cut up by the intervention of a third commodity—every commodity being first exchanged for money and the latter for any other commodity. Any commodity chosen by common consent to serve as a measure of value and medium of exchange between all other commodities and services can be called money.

The history of evolution of money reads like a romance. So long as the article chosen to serve as money was familiar, easily recognisable and readily acceptable, its nature was a matter of little concern. Different kinds of objects have been used in different countries at different times to meet the necessity for a medium of exchange and measure of value. Perhaps one of the first standards of value in the early stages of civilisation

was comprised of leather and furs. These were used as money in Rome and later on in Russia during the reign of Peter the Great. In the eighteenth century the Hudson Bay Company used skins as money and the Indians of Alaska still use it as a medium of exchange. Similarly, the Romans are said to have used oxen as standard of value. Cowrie shells, pieces of salt, iron and copper have served the purpose of currency from time to time. In Virginia tobacco has been similarly used. Blocks of compressed tea were used as medium of exchange in some parts of China. Olive oil was for some time used as a means of effecting exchange in some parts of North America. So have dates been used as money among some of the primitive tribes of North Africa. Likewise, reindeers among the Laplanders, fish among the fishing peoples, rum in New South Wales, articles of ornaments and arms and tools have been and still in some cases are used as media of exchange. In Indian villages corn is even to-day a popular medium of buying and selling.

Apart from their inconvenient handling, these articles possess little permanent and very uncertain material value in themselves. In addition to possessing some attraction in itself, the article to be used as money should be more durable, stable and compact. By degrees the precious metals,

specially gold and silver, because of their general superiority and usefulness, began to be recognised as the best commodity for money. Ultimately coins were found to be of greatest utility for this purpose. But due to their expensiveness, precious metals are being replaced by paper money; and to-day every civilised community supplements its metallic currency by paper money, thus economising the use of precious metals.

There can be hardly anything of greater importance to the civilised business world than money. It is intimately connected with man in almost every department of his life. To-day a money value is attached to every commodity and service.

Money serves as a

- (1) Medium of Exchange,
  - (2) Measure of value,
  - (3) Standard of value for deferred payments,
- and, (4) Store of value and hence a means of capitalisation and an instrument for transferring property from hand to hand and place to place.

In modern society only a small part of the wealth produced is directly consumed by the producers themselves. Each individual for the most part lives on the things produced by a host of

producers which he gets in exchange for the goods and services he himself has produced. Under the crude system of barter exchanges of goods and services are direct, few and seldom. But with the advancement of civilisation, the increase in the division of labour, the diversification in the number and character of wants, the multiplicity of commodities to be exchanged and the growth in the number of the acts of purchase and sale, direct exchange becomes not only cumbersome but actually impracticable. The intervention of a third commodity, which can facilitate the distribution of goods and services according to the needs and conveniences of those among whom they are shared, becomes indispensable. Thus, it was in the civilised society that the need for a rapid and ready intermediary of exchange was first felt and money became an actual necessity for production.

Introduction of money is a great advantage to trade. When goods are directly exchanged for goods a relationship has to be established in respect of every commodity forming the subject-matter of exchange. The introduction of a new commodity or service involves fresh calculations. This results in considerable amount of confusion. When an article of comparison is adopted by common consent to serve as a scale of values in terms of which every other commodity can be

measured, the difficulty disappears, and the value of every thing is expressed and compared in terms of money.

— To the commercial community it is value which concerns more than anything else. In every contract a shorter or longer period elapses between the incurring and the liquidating of the obligation. If the standard of value is erratic, the creditor cannot be assured of getting the same amount of purchasing power which he gave when the debt was contracted. All contracts for deferred payments become mere gambling if the settling medium is inconsistent in value. Though money serves as a standard for deferred payments, its value cannot be perfectly stabilised.

— In order to practise abstinence, a man must be assured of the fruits of his labour. If the results of labour deteriorate by the consuming action of time, no sensible person would save wealth and there would be no capital. Money, because of its comparatively stabler nature, serves as a store of value which can be easily transferred without loss from person to person, time to time and place to place. It thus helps the growth of capital.

Money helps the distribution of national wealth among the different factors of production. Besides helping to equalise the marginal utility in expenditure, it serves as a proper basis for the sys-

tem of credit.

For the proper performance of its functions, money should be composed of a commodity which possesses the following attributes:—

(1) *Valuability*:—It should possess some utility in addition to its monetary use. This attribute is essential only up to a certain stage in the evolution of money. To-day, for instance, a bank or currency note which is made of paper and the value of which is practically nil, under certain conditions, circulates side by side with and often with greater facility and convenience than metallic money. In fact it is the right to demand metallic currency for these notes that makes them circulate as currency.

(2) *Stability*:—If the money material frequently changes in value, it cannot satisfactorily serve as a good store of value and an efficient standard for deferred payments.

(3) *Indestructibility*:—The commodity should be durable otherwise it cannot be stored.

(4) *Portability*:—A satisfactory money must be made of a commodity which has a high value for its volume. This helps in storing money and transferring it from one place to another.

(5) *Homogeneity*:—The commodity should be capable of being divided into fractions for making smaller payments without in any way losing its



value. Similarly, its portions should be aggregatable, *i. e.* capable of being put together into a single mass without any loss of value.

(6) *Cognisability*:—Money should be easily recognisable. Most of the modern coins are recognised by their colour, weight and sound.

(7) *Malleability*:—The money material should be suitable for purposes of coinage.

The word money, as it is used in the ordinary language, has altogether a different meaning from that in economics. Sometimes the term denotes nothing more than metallic currency. Used in another narrow sense, the term includes only coins and paper money. When used in a wider sense, it describes not only the metallic currency and paper money but all other instruments of credit of general and restricted circulation. To be more precise, money is anything which freely circulates from hand to hand without any reference to the credit or character of the person tendering it, and is received in full payment for commodities and services to be used for no other purpose than to be again tendered in return for goods and services.

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## CHAPTER II

### COINS AND COINAGE

With a view to obviate the trouble and inconvenience of weighing and assaying bars and ingots of the chosen metal, which formed the first metallic media of exchange, at each inter-change of goods, shaped pieces of metal with their weight and fineness duly marked on them were introduced. In this form money could be easily ascertained and counted. Another stage in the evolution of money is marked by the adoption of stamped and certified pieces of metal of uniform size, shape and weight, which are known as coins.

In China coins were made as early as 2250 B. C. The metallic bars, which were cumbersome to handle, were divided up into pieces of different values so as to serve the purpose of smallest purchase and sale without any weightment. As the coins were certified pieces of metal, bearing the stamp of the Government, the holder could be assured of their quality and value. Thus, to the extent of its value, each coin became an order, drawn on whomsoever it was presented and payable to the bearer on demand.

Manufacture of coins is known as coinage.

The work of coining metallic money is usually the monopoly of the State; and the official place where coins are manufactured is called the mint. A good system of coinage aims at securing uniformity and convenience in size, shape and weight of the same kind of coins and preventing their fraudulent use by counterfeiting and clipping.

Due to difficulty of manufacture and softness of some of the precious metals like gold and silver, coins are not generally made of a single pure metal, but some other baser metal, called alloy, is added to make them sufficiently hard. The weight and fineness of each type of coin issued by the mint is fixed by law. The rate at which the mint accepts gold for coinage is called the mint price of gold. In England the mint price of gold is £3. 17s. 10½d. per ounce of standard gold, *i. e.* each ounce of gold of eleven-twelfth fineness is manufactured into about 3.894 sovereigns. The prescribed weight of the coin issued by the mint represents its standard weight. The term standard fineness or purity indicates the proportion of alloy to pure gold contained in a coin. Due to the difficulty of manufacturing every coin of exactly the same weight and purity, the law permits a certain degree of variation in coinage from the standard weight and fineness. This is known as remedy.

Coinage may be free or limited. It is free when every citizen has a right to take his bullion to the mint and have it converted into coins. Under the system of limited or restricted coinage, coins are manufactured only on Government account, and private individuals are not allowed to get their bullion minted.

Coinage is gratuitous if no fee is charged for converting bullion into coins. When a fee, just equal to the cost of manufacturing the coins is charged, it is called brassage or mintage. On the other hand, if the fee charged is in excess of the actual cost of minting, it is known as seigniorage. The term seigniorage is also oftentimes used to include the mintage. Seigniorage may be taken either by mixing a certain proportion of alloy to the precious metal in the coin or by making a direct charge over and above the actual cost of coinage.

Those who support gratuitous coinage hold that it is the function of the State to provide efficient currency and hence no fee should be charged for coinage. Since the expenses of minting are very small, they should be met out of the public purse. Further, the value of gold as bullion and as coin, under a system of gratuitous coinage, remains at the same level, and the effect of any inflation or deflation of currency is corrected by an automatic

inflow and outflow of the metal to and from the country.

On the contrary, those who hold the opposite view assert that coins are a real boon to the civilised community, and so a small charge for coinage can be justified. Furthermore, coins are more useful than bullion. They are money. Since it costs something to manufacture and issue the coins, people should pay for it. Besides, this seigniorage discourages the melting of coins.

Coins may be depreciated and debased in various ways. The Government, as the exclusive issuing authority, may depreciate the value of its metallic money by manufacturing and issuing coins in excess of the actual needs of the community. Another method of debasement may be adopted by the State when it issues coins much below the prescribed weight or fineness. Coins may also be debased by clipping, sweating or abrasion. In modern times most of these methods of debasement have been brought under control, and any counterfeiting of or tampering with the coins is severely punished.

Coined money is of two types, viz. standard money and token money. A standard coin is generally made of some precious metal and its denominational value is equivalent to its metallic value. It is subject to free and gratuitous coinage

and the values of all other kinds of money are adjusted to it. A token money is usually made of a baser metal. It is not intrinsically worth its value in exchange, and as such, it has a restricted coinage. Token coins are utilised for making smaller payments.

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## CHAPTER III

### PAPER CURRENCY

In a civilised community the circulating media of exchange does not wholly or indeed mainly consist of metallic money. Besides the inconvenience in their handling, the precious metals, when largely used as coins, become very expensive and uneconomical. The rapid growth of industry and trade has necessitated the use of a large amount of substitutes for coins which have considerably economised the use of costly metals. One of the substitutes, which civilisation has adopted, is paper money, the value of which is regulated and maintained by law. Money is nothing more than an order giving its possessor a right to demand, under certain circumstances, a share of the existing wealth of the community. The part played by an order can be taken up by a piece of paper as well as by a piece of metal. Paper money is issued by Governments and banks.

The currency of a country includes both metallic money and paper money which circulate from hand to hand in monetary transactions. Sometimes the term is used in a wider sense to denote the different kinds of media of exchange including

credit instruments as well. Legal tender money is that which a creditor is bound by law to accept in settlement of a debt owing to him.

There are three kinds of paper money, *viz.* representative paper money, fiduciary paper money and conventional paper money.

Representative paper money represents an equivalent amount of coins or bullion deposited somewhere. Besides being economical to use and convenient to handle, it is perfectly safe, as it is fully secured by actual metallic reserve exactly equal to its denominational value. Representative paper money is akin to bullion certificates.

Fiduciary, convertible or redeemable paper money consists of a promise to pay a certain sum of metallic money on demand. Since the holders of paper money do not convert their notes all at once, the amount of metallic reserve kept for securing their redemption is much smaller than the aggregate nominal value of the notes issued.

Conventional, inconvertible or irredeemable paper money consists of notes which cannot be redeemed in coins or bullion on demand. Inconvertible paper notes may be taken as money upon which a seigniorage of hundred per cent is charged. Conventional paper money, like the American greenbacks, may be irredeemable from the time of its issue. It may also consist of notes which are



issued as convertible paper, but which, like the French assignates, later on cease to be so on account of the subsequent insolvency of the issuing authority.

When inconvertible paper money is issued by a Government without any intention to secure its conversion, it is called fiat money. Walker calls inconvertible notes political money and all other forms of money economic money.

The earlier economic thinkers maintained that the creation of paper money was equivalent to the creation of wealth, since the aggregate stock of wealth of the community was increased by the amount of paper money created. This view has now been refuted. Only to the extent the paper money replaces and liberates the metallic currency, it increases the wealth of the community and nothing beyond that. If half the metallic money in actual circulation in a country is replaced by the creation of paper money of that value, the liberated stock of metal is available for purchasing commodities from foreign countries and investing it in domestic agriculture and industry, and by that amount the wealth of the country is increased. Convertible paper currency, if judiciously issued and circulated, possesses certain decided advantages over metallic money.

On account of its superior portability, paper

money is more convenient to handle and economical for making payments in large amounts and to distant places. Besides this, the creation of paper money within certain limits releases from circulation a part of the metallic money which can be invested in home industries or utilised for making payments abroad. Further, to the extent the paper currency releases metallic money, it saves the loss through wear and tear which the coins undergo in circulation. If paper currency is universally adopted, a considerable amount of labour and capital required for mining the metals for coinage in different countries can be used for various economic purposes. When a Government borrows money to meet its obligations and expenses, it has to pay interest on the debt which it can save if it issues paper money instead of contracting loans for these purposes. Again, the value of precious metals is sometimes more liable to fluctuate than that of judiciously regulated paper currency.

In spite of these advantages, paper currency suffers from several defects. The value of paper money is all a matter of convention and law. By a mere stroke of pen the issuer of paper money can demonetise it at any moment when the holder will lose every thing. Metallic money, on the contrary, over and above its face value, possesses

an intrinsic value, which is a sure guarantee of value to the holder. Again, the circulation of paper money is limited only to that political area where the law gives it a value in exchange. Because of the total absence of intrinsic value in it, paper money cannot circulate outside the borders of a country, according to whose law it circulates as currency. Paper money is, thus, a national money. Metallic money, on the other hand, is essentially an international money. It is always accepted by foreigners according to its intrinsic value. Since the supply of paper money is all a question of fancy of its issuer, its value is more liable to change than that of metallic money, the supply of which, due to limited national resources and high cost of mining and minting, cannot go up to any limit. According to Prof. Gide, these objections can be obviated if a uniform system of international paper money is adopted by all the leading nations of the world.

Convertible paper money is issued either by Governments or by banks. When issued by Government, it is usually secured by a redemption fund or only by the credit of the issuer. Bank money consists of convertible paper issued by a bank which it undertakes to redeem on demand in legal tender money. Bank notes are fully or partly backed by metallic deposits and are issued

in response to the demand of business community. If the demand for currency increases, businessmen discount their bills with the bank and take notes in exchange. Bank notes may also be issued against metallic deposits. Similarly, when the demand for currency slackens, the holders take their notes to the bank and have them converted into metallic money or bullion. This automatic expansion and contraction of currency in response to the demands of business is called elasticity of currency.

Bank notes may be issued according to banking or currency principle. All notes issued according to currency principle are fully secured by an equivalent reserve of metallic backing; and as soon as the metallic reserve is reduced, a corresponding amount of notes is cancelled. Currency principle makes the issue of notes secure but inelastic. According to the banking principle, the issuing bank is not required to keep full metallic reserve for all the notes issued. This is based on the presumption that all the notes issued will not be presented at one and the same time. Under the banking principle, the bank is allowed to regulate the supply of notes according to the demand of the community. Advocates of this principle maintain that if there is sound banking there is no danger of over-issue and depreciation of notes.

Notes issued under the banking principle, though more elastic, are less secure than those issued under the currency principle. A modified system of banking principle, which combines some of the safeguards of currency principle within proper limits, makes the issue of notes adequately safe and sufficiently elastic.

The term fiduciary issue is applied to a fixed limit up to which the issue of notes may be backed by securities instead of precious metals—every note issued beyond this limit being fully secured by metallic cover.

Besides combining the advantages of convenience of handling, economy in use and stability of value—advantages which are common to all forms of convertible paper—Government convertible paper possesses an additional fiscal advantage of securing some revenue for the State without necessitating any additional direct taxation. Convertible bank notes, on the contrary, possess greater elasticity of circulation than Government notes.

Certain objections are, however, raised against the issue of convertible paper by the Government. In the first place it is contended that it is not the proper function of the State to issue notes. Secondly, according to the testimony of experience, Governments have many a time failed to maintain the convertibility of their notes. Thirdly, there

is greater danger of excessive issue of Government paper money than of bank notes. Lastly, bank notes possess greater elasticity than Government convertible paper.

But those who object to the issue of convertible bank paper, assert that the business of issuing notes, when performed by private banks, places great money power in the hands of these institutions, which may be used for personal motives against the interest of the whole community.

With all these advantages and limitations, the best convertible paper money is perhaps that which is issued by the bank and controlled by Government.

Inconvertible paper is generally issued by Governments, though banks may also be authorised by law to issue this kind of currency under certain conditions. Besides possessing the advantages common to other forms of paper money, inconvertible paper obviates the necessity of maintaining a reserve fund to secure its redemption. But this type of currency suffers from serious disadvantages, inasmuch as it offers a strong temptation for over-issuing it, which lowers its value and artificially raises the price level; introduces an element of uncertainty and a spirit of gambling; makes business unstable and risky; gives rise to speculation and encourages extravagance and waste by

raising the money price of goods and property and making people think that they are richer than what they actually are. Furthermore, a rise in prices, resulting from the depreciation of currency, is not usually followed by a corresponding rise in wages and salaries, so that it brings hardship to salaried persons and wage earners. Another evil of over-issue of inconvertible paper is that it displaces metallic money from circulation and reduces the quantity of bullion for use in the arts—the coins and specie thus released being hoarded, melted or exported to foreign countries. For further elucidation of this subject the reader is referred to the chapter on Gresham's Law.

An issue and circulation of paper money tend to drive out metallic currency from circulation. The larger the issue of inconvertible paper the greater the displacement of coins. If the amount of metallic money displaced is less than the quantity of conventional money issued, there is an over-issue of inconvertible notes to the extent of this deficiency.

Excessive issue of inconvertible paper is attended by a number of signs and symptoms. Irredeemable paper currency, when issued in excess of the needs of industry and trade, depreciates in value. If it circulates side by side with metallic money, the coins which retain their

former value always command a premium in terms of depreciated paper. Since paper money is not accepted by foreigners, those who purchase specie to make payments abroad will pay this premium. The difference in the value of specie and depreciated paper is called *agio* or premium. A premium on precious metals, like gold and silver, is followed by a rise in the price of foreign bills of exchange, which are payable only in metallic money, and this is reflected in a rise in the rate of exchange. Rate of exchange denotes the price at which foreign bills are bought and sold.

By an over-issue of inconvertible paper, metallic money is driven out of circulation under the operation of Gresham's Law. When over-issued, inconvertible paper money artificially forces up the internal price level of the country, which is entirely different from the world price level.

If the Government agrees to accept its inconvertible paper in the form of taxes, or promises to redeem it, its value can be maintained to a certain extent. Another practical suggestion for stabilising the price level by preventing any over-issue of irredeemable paper currency is to regulate its supply according to the demands of business, which can be gauged by measuring the fluctuations in the price level and watching the symptoms of



excessive issue.

If, by a common agreement, all the countries of the world adopt an international paper money in place of other expensive media of exchange, there would be considerable economy and convenience, and most of the currency and exchange problems of different nations would be easily solved.

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## CHAPTER IV

### MONETARY STANDARDS

One of the most cherished objects of a currency policy, but the one most difficult of attainment is to have a stable standard of value. Perfect stability is a convenience rather than a condition. Money cannot be as accurate a measure for value as a yard is for length or a maund for weight.

Standard of value is the basis on which the currency of a country is measured and regulated. A good standard money should be freely coined and should be made an unlimited legal tender. The less a metal fluctuates in value the better it is suited for standard money.

When in a monetary system the standard unit of money consists of a single metal, whether gold or silver, it is called single standard or mono-metallism. The term bimetallism or double standard system, on the contrary, is used to designate a monetary system in which the standard money is composed of two metals, generally gold and silver, both freely coined and both circulating as unlimited legal tender at a fixed legalised ratio of exchange between them. However, under both

the currency systems token money of baser metals and of smaller denominations is used as limited legal tender for smaller payments. Limping or halting bimetalism means a monetary system in which two metals are unlimited legal tender but only one of them is freely coined.

While under monometallism the standard money and the standard of value is formed by a single metal which is subject to free coinage and is made unlimited legal tender, under bimetalism it is composed of two metals both of which are freely coined and circulate as unlimited legal tender at a fixed ratio.

If a monetary system adopts gold as the standard of value, it is called gold monometallism or gold standard. Due to its superior intrinsic and stabler value, gold is the favourite standard adopted in monometallism.

On account of its high value in small bulk, gold, if adopted as a single standard of value, proves relatively more economical and serviceable to the people of industrially advanced countries. There is every reason to believe that with the growth of industry and advancement of science the supply of gold from different sources will not be very much short of its requirement for monetary purposes should gold monometallism be progressively adopted by the various countries of the

world. Further, variations in the value of a single metal forming the standard of value cause less difficulties in the long run than fluctuations in the value of two metals, both of which constitute the standard money. Again, single standard is less complicated than double standard.

Bimetallism, as we have seen, adopts two metals—usually gold and silver—as principal or standard money, both of which are freely coined and circulated as unlimited legal tender at a legally fixed ratio.

Advocates of bimetallism maintain that if a ratio of exchange between two metals used as standard money is carefully fixed and the system applies to a sufficiently wide region, the chances of fluctuations of the ratio are reduced to a minimum. Bimetallism, by increasing the total stock of standard money, reduces the chances of fluctuations in prices. By making two metals as standard money, bimetallism makes the maintenance and regulation of banking reserves simpler and safer. In international trade money goes by weight and not by tale. Unless all the trading countries adopt bimetallism at an agreed ratio of exchange between two metals forming the standard money, international trade remains an uncertain affair, for payments among different nations adopting different standards of value consisting of different

metals cannot, because of constant fluctuations in their values, be made on a definite and stable basis. A slight change in the value of the metal adopted for standard money, upsets the calculations of exporters and importers and saddles them with huge losses. Under bimetallism a par of exchange is fixed between countries adopting this monetary system, and payments to foreigners can be made in any one of the two metals at a fixed ratio of exchange. Some thinkers believe that a gradually depreciating money is the most desirable characteristic of a sound money system for, by slowly raising the price level, it stimulates industry and trade. This is more practicable under bimetallism than under monometallism, where a restriction in the supply of standard money, due to limited supply of gold, may actually scale down the prices. It is argued that if a large number of commercially strong nations adopt bimetallism over a sufficiently wide zone, the chances of fluctuations of the legally fixed ratio of exchange between the metals forming the standard money are, by the process of compensatory action of bimetallism, considerably minimised. This will happen thus: If the legalised ratio between gold and silver is, say, 1 : 16—one ounce of gold exchanging for 16 ounces of silver—and the value of silver, due to its increased supply, falls so that the market ratio of

exchange between the two metals becomes 1 : 17, under the operation of Gresham's Law, silver will be under-valued in terms of gold and it will tend to drive gold out of circulation. The demand for silver for purposes of coinage will increase and the supply of gold will increase in the market by melting down the gold coins. These double movements of demand and supply of the two precious metals will tend to correct the disparity between their mint and market ratios. Thus, bimetallism secures greater stability of prices than monometallism. Against this line of thought, it is argued that with industrial development and advancement of civilisation countries are gradually giving up the use of silver as currency and are increasingly taking to gold monometallism. If under bimetallic fluctuations the supply of gold currency increases, it will depreciate all the more. Thus, the bimetallic ratio of exchange between two metals can never remain stable. The supply of currency consisting of two metals is greater under bimetallism than under a system of single standard. The effect on prices of a decrease in the supply of one metal is thus counteracted by an increase in the supply of the other. Bimetallism lessens the intensity of fluctuations in the price level. But it has been seen above that fluctuations in the ratio of exchange between

two metals under bimetallism is always possible, and the standard of value always fluctuates from one metal to the other. Moreover, the frequency of fluctuation in prices is increased under bimetallic system, because the value of money is governed by the conditions of supply and demand of two metals instead of only one, as under monometallism. And frequent fluctuations are worse than a sharp variation extending over a long period. When under bimetallism one currency depreciates in terms of the other, the creditor wants that his debt should be cleared in terms of good money but the debtor wants to pay in bad money. This gives rise to constant friction between different sections of the community. Further, a difference between the market ratio from the legal ratio of the two metals produces speculation and its attendant evils.

If isolated countries adopt bimetallism as their monetary policy, the system becomes unworkable. But if international bimetallism at a fixed ratio is established by a common agreement among most of the commercially strong nations of the world, bimetallism becomes possible. International bimetallism secures a par of exchange between gold and silver using countries.

In face of all these advantages, international bimetallism is not practicable due to certain

objections. Gold monometallism carries with it a certain amount of prestige which no gold standard country is prepared to risk. Further, each country has its own ratio of coinage between gold and silver. If a common ratio is adopted, it would upset the monetary system of all the countries. Again, the creditor nations are opposed to bimetallism because they apprehend that payment of their debts will be made in terms of depreciated silver. Even if international bimetallism is adopted, the banks and Governments who expect a further depreciation of silver, will keep only gold in their reserves, and thus the system would break down. By changing the current price level, bimetallism will violate the existing contracts. It will impede economic progress.

Those who can stretch their memory as back as fifty years or more need scarcely be reminded of the time when bimetallism had become the watchword of the monetary world. The Great War has taught many severe lessons. On account of the strong opposition of some of the leading nations of the world, the apprehension of the business world, coupled with numerous practical difficulties, bimetallism, as an international monetary system, has lost its charms. The triumph of gold monometallism is unquestionable.



Gold is the basis of monetary system everywhere. The adoption of gold standard establishes an international standard of value. Expansion of currency and credit and movement of exchange are automatically adjusted to each other under gold standard. An effective gold standard implies confidence ; and this is the greatest advantage of gold monometallism.

Against these merits, the defects of gold standard are : First, because of its uncertain supplies, the fluctuating value of gold makes it an unstable standard. Secondly, the expansion of credit depends more on the supplies of gold than upon other economic conditions. Thirdly, under gold standard the internal and external price levels are intimately related, so that a change in foreign prices is followed by a sympathetic movement in the home prices. This is a sacrifice of internal price stability at the cost of exchange stability. Lastly, recent financial history has vividly shown that without international goodwill and confidence an effective gold standard is unworkable.

A modification of gold standard is what is known as the gold exchange standard, the characteristics of which are : First, two kinds of money, one local and the other international, circulate as unlimited legal tender without the free coinage of either of the two. Secondly, the local currency,

which is mainly not of gold, is used for domestic payments. Thirdly, the international currency, which consists of gold, is used for foreign transactions and is given in exchange for the local currency at a certain maximum ratio. Fourthly, a reserve of gold and foreign credits is maintained for conversion of internal currency into external one.

Gold exchange standard is a compromise between gold and silver standards. It combines the advantages of both monometallism as well as bi-metallism. Gold exchange standard is cheap and economical. It consists of cheap local currency and economises the use of gold in domestic transactions. It possesses the advantage of stabilising foreign exchanges. In the opinion of some people gold exchange standard is the future monetary standard of the world.

During recent times another standard of value, known as gold bullion standard, has acquired considerable importance. The main features of this standard may be thus summarised : "Gold bullion, but not gold coin, must be freely issued and accepted by the Central Bank in exchange for legal tender currency. Circulating legal tender notes are not convertible into gold coin, and a holder of gold bullion is not entitled to demand that it shall be minted into gold coin." Under this

system the legal tender notes are convertible into external gold currency not for domestic purposes but only for international payments.

Gold bullion standard is a wise compromise between gold standard and gold exchange standard. It secures the advantages of gold monometallism for making international payments and of gold exchange standard for internal transactions. It economises the use of gold. Gold bullion standard is a standard without gold currency. It is less costly than gold standard and inspires more confidence than gold exchange standard. It secures greater stability of value and leads the country on the road to an effective gold standard with gold currency.

Without a cosmopolitan spirit of good-will and co-operation, confidence and mutual dependence, no monetary standard, be that a single standard or a double standard, gold exchange standard or gold bullion standard, can claim the attribute of stability of value, an attribute, most cherished but most difficult of attainment.

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## CHAPTER V

### GRESHAM'S LAW

In spite of numerous penal laws, the past monetary history of most of the countries of the world is coloured with fruitless attempts to maintain the currency in a proper state of repair. From time to time new coins were issued to replace old ones, but they themselves disappeared, and only worn, clipped and debased coins of divers shapes and weights were left to circulate. This brought fortunes to the rich and poverty to the poor.

One of the most important but at the same time the most neglected economic laws about the circulation of money is what is known as Gresham's Law. It is named after Sir Thomas Gresham, the founder of the London Royal Exchange and the chief financial adviser of Queen Elizabeth.

Though of general applicability, the law specially applies to coinage and is based on human nature. Applied generally, the law may be stated thus: If a man possesses two things which he can put to the same use, he will use that thing which he likes less. Expressed particularly with reference to circulation of money, the law is: Bad money drives out good money out of circulation, but good

money cannot drive out the bad.

When the face value of a coin coincides with its intrinsic value, it is a good or sound money. If, on the other hand, the legal value exceeds the metallic value, the coin is a bad money. A coin is called a heavy money when its bullion value becomes higher than its denominational value. Under a system of free coinge, the legal value always tends to coincide with the bullion value; for, if the value of the coins as bullion increases, they will be melted and their supply will be decreased, so that their nominal value will be forced up. Similarly, if the legal value is higher than the intrinsic value, more money will be coined, and an increase in the supply of coins will bring down their nominal value at par with the metallic value.

If good money and bad money circulate side by side, only bad money will remain in circulation, because people will keep the good money for themselves and use only the bad money for exchange purposes. Since good money has higher value as bullion than as currency, it will be withdrawn from circulation and hoarded, melted or exported abroad for making foreign payments. Thus will bad money drive out good money.

If the law recognises good and bad coins as of equal value, the better coins will disappear in three ways. First, those who want to hoard

money will select superior coins for this purpose. Secondly, the better coins, because they possess a higher value out of circulation than in the circulation, will be melted down and sold as bullion. Thirdly, as in international payment money goes by weight and not by tale, a considerable portion of good money will be exported to foreign countries in discharge of international commitments where its superiority will be more advantageous than when it is used for payments at home where its value is the same as that of bad money which has comparatively smaller value outside the country.

Gresham's Law has a particular application to circulation of money. If clipped, sweated and worn out coins command the same value as currency as new coins of full weight, the newly coined money will be driven out of circulation by being hoarded, melted and exported. This can be expressed thus: "If coins of the same metal, but of varying weight and quality, circulate together at the same nominal value, the worse coins will tend to drive the better from circulation, but the better will never drive out the worse."

Further, "if coins of two precious metals be circulated at a fixed ratio of exchange with one another, the over-valued metal will tend to drive the under-valued from circulation." When two

metals circulate together as currency, they have two ratios of exchange—one, the mint ratio, which is fixed and is determined by law and the other, the market ratio, which is variable and dependent upon the bullion value of the two coins. In spite of all attempts to keep the two ratios at one level the coincidence becomes more a matter of chance than of general rule, and the over-rated metal tends to drive out the under-rated from circulation. This happens in this way. Suppose two metals—gold and silver—circulate at a fixed mint ratio of 1 : 16 as currency, and the market ratio of exchange between them is, say, 1 : 15. In this case gold is the over-valued metal, because one ounce of gold can be exchanged for sixteen ounces of silver at the mint and only fifteen ounces in the market. Similarly, silver is under-valued in law. What will happen in this case is that the holder of silver currency will exchange fifteen units of silver coin for one unit of gold coin in the market, take the gold coin to the mint, get sixteen units of silver coin in return for it, retain one unit of silver coin for himself and again sell the remaining fifteen units in the market, thus every time making a profit of one unit of silver. By this process the silver currency will be melted and sold as bullion and only gold coins will be retained in circulation.

In still another form, the law applies to a

currency which consists of two kinds of money, one of coins and the other of depreciated paper, both circulating side by side. In such cases the depreciated paper, being bad money, tends to displace the metallic currency which is good money.

Notwithstanding its wide application, the Gresham's Law suffers from its limitations. So long as the aggregate stock of currency is not in excess of the requirements of business, the bad money, in spite of its inferiority, is retained in the circulation. Again, if on account of the force of custom or public opinion, people refuse to use bad money as currency, bad money, instead of good, may be driven out of circulation.

History reveals that the principles underlying the Gresham's Law were vaguely surmised but not clearly grasped by the ancient Greeks. The credit of giving it a scientific form, however, goes to Sir Thomas Gresham. Its application to the currency policy of different nations at different times makes it a subject of special interest to the student of monetary history.

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## CHAPTER VI

### VALUE OF MONEY

Combining the attributes of elasticity and economy, a good monetary system aims at stabilising the value of money. While perfect stability of value is difficult of attainment, a nearest approach to it should be the end to be sought.

The value of money refers to its purchasing power, *i. e.* the quantity of different things for which it can be exchanged. Value of money can be variously expressed in terms of different commodities which it can purchase. When the value of a thing is expressed in terms of money it is called price. But the value of money itself cannot be expressed as price. Purchasing power and price level always move in opposite directions. For, if a unit of money purchases more of a thing, the price of the latter falls. Similarly, high price is indicative of low purchasing power.

Like the value of any other reproducible commodity, the value of money is determined by the interaction of the forces of its demand and supply.

The amount of money required to do the work of exchange constitutes the demand for money. The whole stock of wealth produced in a country

is not exchanged through the medium of money. A part of it is directly consumed by the producers. Still another part is exchanged by barter. In a civilised community the use of credit greatly helps the work of exchange without the intervention of money. New money is demanded only for that part of the exchange work which is actually done through its medium.

The money force available to do the exchange work constitutes the supply of money. This money force depends upon the volume of money and the rapidity with which it circulates. For, if one rupee changes hands only once a week and the other performs five exchanges within the same period, it is obvious that the latter coin does the work of five former coins.

The most celebrated theory about the value of money, is known as the quantity theory of money. Expressed in its simplest and bald form, the theory is: The value of money varies inversely as its supply and directly as its demand, or in other words, every change in the volume of money in circulation is followed by a directly proportional change in the prices.

The theory is based on certain assumptions. In the first place, it assumes that the demand for money remains unchanged. Secondly, it holds good only of a society where only one form of

money circulates and every piece of money is exchanged only once; where there is no use of credit nor the practice of hoarding or barter; where all wealth that is produced is exchanged and the volume of trade does not change; where the demand for money remains fixed and the habits of people unaltered. In such a hypothetical state of society the value of money changes exactly in proportion to its volume. That is to say, if the supply of money is doubled its value is halved and the price level is also doubled. And, if the supply of money is reduced by fifty per cent, the price level is halved and the value of money is doubled. Similarly, the converse would also be true. In all these cases the demand for money has been taken to be unity.

A crude theory, as the quantity theory of money is in its unqualified form, might apply to a simple and primitive society but in a modern society, with so many complicated factors giving rise to demand for and supply of money forces, the relation between the volume and value of money is not so close as it enunciates.

In its qualified and developed form, the quantity theory of money may be thus stated: Other things being equal, an increase in the quantity of money proportionately raises the price level (and lowers the value or purchasing power of money);

(and a decrease in the quantity of money proportionally lowers the price level (and raises the value or purchasing power of money).

The qualifications underlying the expression "other things being equal" are: First, the more rapidly does a piece of money circulate the more exchange work it performs. This is the same in effect as increasing the supply of money. Secondly, if the volume of trade expands, the same quantity of money will have to perform greater amount of exchange which will be the same in effect as a reduction in the supply of money. Thirdly, if some amount of exchange is effected by barter, the available stock of money will have to do less of exchange work, which will be the same in effect as increasing the supply of money. Fourthly, the use of credit in exchange lessens the use of money for buying and selling, and this has the same influence on prices as that resulting from an increase in the supply of money. Lastly, if a part of money is hoarded or used otherwise than as currency, its effect will be the same as that of a decrease in the quantity of money.

Thus, the quantity theory of money is true of modern times only when the volume of trade, the scope of barter, the use of credit, the rapidity of circulation of money and the habit of hoarding remain unaltered. When these change, the influ-

ence of the quantity of money on prices is neither proportional nor direct.

Professor Irving Fisher formulates the quantity theory of money in the form of the following equation of exchange:

$$\frac{MV \times M^1 V^1}{T} = P$$

where M represents the quantity of money,  
 M<sup>1</sup> represents the quantity of credit,  
 V represents the velocity of circulation of money,  
 V<sup>1</sup> represents the velocity of circulation of credit,  
 T represents the volume of trade,  
 and, P represents the price level.

According to this formula, if V, M<sup>1</sup>, V<sup>1</sup> and T are fixed, P (the price level) rises proportionately as the supply of M. Thus, other things being equal, the price level of commodities is determined by the quantity of money.

Professor Chapman expresses the quantity theory of money as follows:

$$P = \frac{T}{MV \times M^1 V^1}$$

Here P denotes the purchasing power of money,  
 T denotes the volume of trade,  
 M denotes the quantity of money,

$V$  denotes the velocity of circulation  
of money,  
 $M^1$  denotes the quantity of credit,  
and,  $V^1$  denotes the velocity of circulation  
of credit.

According to this formula, if  $T$ ,  $V$ ,  $M^1$  and  $V^1$  are fixed,  $P$  (the purchasing power of money) varies inversely and proportionately as  $M$ .

On account of the durability of precious metals and the speculative character of the sources of their supply, their value, unlike the value of other commodities, is not determined by their marginal cost of production.

Though paper money has no intrinsic value, its nominal value and bullion value can be kept at par by limiting its supply. The value of inconvertible paper, unlike the value of metallic money, does not vary proportionally and in inverse direction as its quantity even if the other things are equal. This is because its over-issue destroys the confidence of the people, and this pulls down its value more than proportionately.

In its bald statement, the quantity theory conceives of a static society which is an exception rather than the rule. Society is dynamic and not stationary. "Other things" are rarely equal in the tension of economic forces. The volume of trade, the amount of credit, the velocity of circulation of

money and credit and the habit of hoarding, all these are changing and variously affecting the conditions of demand and supply of money. Again, according to the theory, variations in prices are caused by variations in the quantity of money. In fact the relation between supply and value is not one of cause and effect but of mutual causation. If an increase in the supply of money causes a proportionate rise in prices, a rise in the price level should also cause an increase in the supply of money. But this generally does not happen. Like water, price tends to seek its own level. Further, a change in the volume of money is not always followed by a corresponding change in prices. A slight increase in the supply of money, by encouraging the demand for it, may actually lower the prices, thus raising the value of money. Brisk trade, which usually expands the volume of transactions, is usually a period of high prices. Similarly, slack trade may be characterised by a period of low prices. Some economists object to treat money like other commodities. Professor Cannan maintains that, unlike other commodities, the value of money does not depend on the interaction of the forces of supply and demand. According to him, the demand for currency is furnished "not by the number and amount of transactions, but by the ability and willingness of

persons to hold currency, in the same way as we think of the demand for houses as coming not from the persons who buy and resell or lease or sub-lease houses but from the persons who occupy houses”.

In spite of these objections, the quantity theory of money, in its developed and qualified form, holds good of all times and for all places, and it is accepted by most of the modern economists.

Inflation or expansion of currency means an increase in the supply of money. An inflation of currency, other things being equal, is followed by a depreciation and fall in the value of money, an increase in its purchasing power and a rise in prices. On the other hand, when the volume of currency is reduced, we have a deflation or contraction of currency. Deflation of currency produces an appreciation and rise in the value of money, an increase in its purchasing power and a fall in prices. Inflation or deflation is natural if it is caused by natural forces. If it is caused by the Government, it is artificial.

Appreciation of money may be caused by a diminution in the supply of money—the quantity of goods to be exchanged remaining the same—; an increase in the volume of commodities to be exchanged—the quantity of money remaining



unchanged—; a decrease in the use of credit or barter or a diminution in the velocity of circulation of money or credit even if the quantity of money and of goods to be exchanged remain fixed. Similarly, depreciation of money may be caused by an expansion of currency, the volume of goods to be exchanged remaining the same; a decrease in the volume of goods to be exchanged—the quantity of money remaining the same—; an increase in the use of credit or barter or velocity of circulation of money or credit, even when the supply of money and the volume of goods to be exchanged remain unchanged.

With appreciation the purchasing power of every unit of money is enhanced. Thus, appreciation of money benefits the creditors, the wage-earners and the people with fixed income. But it injures the debtors, discourages production, reduces profits and increases unemployment.

By reducing the purchasing power of every unit of money, depreciated currency benefits debtors, encourages production, increases profits and stimulates business. At the same time it hits the creditors, the wage-earners, the people with fixed income and the consumers. Rising prices, which are the usual attendants of depreciated money, are often followed by crisis and other associated evils.

Neither rising, nor falling, but steady prices

are the best for the community as a whole. The value of money can be roughly measured by index numbers of prices. An index number "is a number which represents the price of a chosen commodity or a group of commodities, or the average of closely consecutive prices of those commodities at a selected date, which is used as a standard where-with we may compare the prices of the same article at later dates".

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**PART II**  
**CREDIT AND BANKING**

## CHAPTER VII

### CREDIT

In the original sense of the term credit denotes belief or trust. But the modern time has given it a far wider meaning. To-day credit refers to solvency of a person to meet his monetary obligations.

Credit is a power which enables one man to induce another to put goods or services at his disposal for the time being in return for a promise to pay for them. In another sense the term indicates credit transactions *i. e.* exchange of present wealth for a promise to pay for them at some future date. In cash transactions present wealth is exchanged for present wealth, but in credit transactions present wealth is exchanged for future wealth. A credit transaction remains incomplete until a certain time elapses. The time element intervening in a credit transaction between the purchase of goods and the payment of its price gives it the nature of protracted exchange.

A credit transaction may take two forms. Either it may refer to a loan of money for a promise to repay the same at a future date, or it may mean a sale of goods in return for a promise to pay for them at some future time.

In its embryonic form credit was used for the purpose of consumption. It was only left for the modern world to use it as an aid to production of wealth. Prof. Hildebrand classifies economic evolution of society into three stages, viz. barter economy, money economy and credit economy. Credit economy is yet in its infantile form. Some economists think that in its full development it will entirely obviate the use of metallic money.

The mechanism by which credit operations are carried out consists of two parts, viz. credit instruments and credit institutions. All kinds of credit paper such as cheques, bills of exchange, promissory notes, bank drafts etc., which arise out of credit transactions are called credit instruments. And banks, as dealers in credit, are credit institutions.

Modern credit is a boon to business world. It enables those, who on account of their age, sex, occupation or lack of enterprise, cannot directly engage themselves in industrial enterprise, to transfer their money in the hands of captains of industry. Credit thus makes sterile capital productive. Again, banks draw large sums of money which are lying idle with the rich people as also very small funds which are similarly lying useless with the poor, and make them productive by lending the same to those who are engaged in in-

dustry and trade. In this way credit makes latent capital active. Furthermore, the credit and reputation of one person may be used with great advantage by another for purposes of trade. This function of credit enables merchants and businessmen to arrange credit and references with banks and deal with unknown parties in distant places. Credit takes the place of expensive media of exchange and economises the use of metallic currency which may be otherwise used as capital. It provides a convenient and cheap means of making large payments to distant places. By enabling the payment to be deferred till it is convenient for the debtor to make it, credit diminishes hardship and difficulty. It is useful to the modern business world in still another way. Proper regulation of credit stabilises prices, stimulates production and encourages trade and economic progress.

But there are several evils connected with credit. Consumption credit is generally squandered and wasted. Fraud and embezzlement are its usual accompaniments. Irresponsible entrepreneurs, utilising mainly the money of others and very little of their own, run into wild speculations and lose, thus bringing hardship and difficulty upon others. Modern system of credit, by concentrating capital in the hands of a few entrepreneurs, places big powers in their hands.

It encourages the formation of monopolies and big combinations and crushes out independent personal aptitude and small scale production. There is no reliable barometer for the issue and regulation of credit, so that when it is created in excess of the metallic reserve and beyond the capacity of producers and borrowers to fulfil their obligations, even the slightest jerk to the confidence of the lenders makes financial crisis imminent.

Various factors determine the volume of credit. Conditions of trade and industry are directly related to the volume of credit—brisk trade co-existing with expansion and slack trade with abridgment of credit. An atmosphere of general security leads to expansion of credit, but when the confidence is shaken, credit quickly contracts. Economic and political outlook at home and abroad, similarly, have a direct bearing upon credit superstructure. A war or spontaneous change of the monetary policy is soon followed by a sympathetic contraction of credit. Again, trade boom and credit expansion go side by side. But as speculative enterprises suffer, the volume of credit also shrinks. Lastly, a sound currency system promotes the expansion of credit.

As the volume of credit produces its direct repercussions on the economic life of the community, it is obvious that its regulation should be

subject to proper control.

Though both money and credit instruments circulate side by side as media of exchange, there is some difference between them. In the first place, money is paid and accepted without any reference to the credit of the person who tenders it, whereas credit has a restricted circulation. Further, instruments of credit are primarily meant for one transaction for which they are created, though they might be used for others as well. But money intervenes between numerous exchanges. An instrument of credit is issued in favour of a certain party for a particular amount, and the title to it is generally transferable by endorsement and delivery which is not the case with money.

The older economists believed that creation of credit was equivalent to creation of capital. This view has been entirely refuted now. Credit, unlike capital, is not an independent instrument of production. It is merely a mechanism by which production is facilitated. Credit is thus a method and not a means of producing wealth. It converts sterile wealth into active capital. Credit instruments represent capital and facilitate its transfer, but they are not capital in themselves.

Credit influences prices in two ways. First, the creation of credit increases the supply of the



available media of exchange and this forces up the price level. Secondly, credit transactions increase the demand for goods, and with the given supply of money, this pulls down the prices.

According to Walker, credit transactions are effected on the level of prices fixed by the given demand and supply of money; and as credit transactions cancel each other, they have no influence on the price level. On the contrary, Mill holds that credit has the same purchasing power as money, and so it affects price to the same extent as money.

Credit transaction is only half the transaction, the remaining half being completed when money is paid. Therefore, for every credit transaction, an equivalent amount of money has to be kept in reserve. Credit has purchasing power but no liquidating power. But money has both. The correct view of things can be seen midway between the two extremes. To the extent the money is kept in reserve to serve as the basis for credit transactions its supply is reduced and it is not available for other transactions. Credit thus tends to lower prices. But the amount of money reserve maintained for liquidating the credit transactions is not really equivalent to the volume of credit created. The excess of credit over the monetary reserve marks the limit up to which the supply of available

media of exchange has been increased, and this has the effect of raising the price level. Therefore, credit raises prices but not to the same extent as money.

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## CHAPTER VIII

### BANKS : THEIR OPERATIONS AND FUNCTIONS

A bank is a person, or firm, or company having a place of business where money and credit are bought and sold.

In every society there are some people who are in need of money and who would be gladly willing to pay something by way of interest if they can get it somewhere. At the same time there are others who have funds beyond their own requirements but do not know how to utilise their money. Thus, neither those who need money know where and how to get it, nor those, who have got it in excess of their needs, know where and how to use it. Acting as an intermediary between these two sets of people, the bank brings the borrowers and lenders together and thus performs a very valuable service to the community. It borrows money in the form of deposits or collections of money and lends it in the form of advances, overdrafts and loans to those who are in need of funds.

Briefly stated, the functions of a bank are :—

1. *Issue of bank notes* :—This privilege is generally enjoyed by only one bank in a coun-

try which is often a State or semi-State institution.

2. *Collection of money on :—*

- (a) Deposit, current and savings bank accounts.
- (b) Account of persons other than those paying the money.

3. *Transfer of money from one place to another :—*

- (a) By paying or collecting cheques, bills of exchange and promissory notes.
- (b) By issuing bank drafts, circular notes and letters of credit.
- (c) By transferring the accounts of customers from one branch to another.

4. *Supply of credit to customers in the form of :—*

- (a) Loans, over-drafts and cash credits.
- (b) Advances on the security property.
- (c) Discounting bills of exchange.
- (d) Accepting bills on behalf of customers.

5. *Miscellaneous :—*

- (a) Receiving valuables from customers for safe custody.
- (b) Purchase and sale of stocks and shares on account of customers.
- (c) Acting as executors or trustees for private persons or estates.

(d) Acting as sureties for customers.

(e) Giving references for customers etc. etc.

Banks have become an indispensable part of the present day economic life, and the services which they perform are numerous and valuable. The advantages of a sound banking system may be described as follows :—

1. Banks encourage thrift, economy, saving and investment. They collect the loanable funds which would otherwise be hoarded or less profitably utilised and make them more productive, thereby increasing the total wealth of the community.

2. Banks provide a convenient and secure place for depositing money, valuables and securities.

3. They finance industry and commerce, and thus encourage production.

4. They provide safe, economical and quick means of transferring money from one place to another.

5. Modern banks, by carefully regulating the supply of credit to industry and trade, check speculation and mitigate the rigours of recurring crises.

6. Cheques, which are the by-product of sound banking system, economise the use of currency.

7. Cheques also provide authentic records of receipts and payments.

8. Banks provide currency and credit which is best adapted to the economic needs of the community.

9. In transacting foreign exchange business, banks facilitate the interchange of goods between two different countries.

10. They often act as sureties for their customers.

11. By acting as referees for their customers, banks greatly help the business community.

A person desirous of opening a banking account first of all enquires about the financial status of the bank where he wants to keep his money and ascertains the rate of interest payable on deposits. It is the common practice with almost every bank that before opening an account with an unknown party it requires him to furnish one or two references from persons known to the bank. The bank then takes the specimen signature of the customer either in an autograph (signature) book or on a specimen signature card, and in addition the following particulars:

1. Full Name.
2. Designation.
3. Postal address.
4. Any special instructions.
5. Date.

The customer must be careful to see that his signature in which he subsequently deals with the bank is identical with that given by him in the autograph book or specimen signature card. This being done, the initial deposit is made and a receipt obtained.

There are three principal types of accounts which a depositor of money may open with a bank. They are :

1. Deposit or Fixed Account.
2. Current, Drawing or Open Account.
3. Savings Bank Account.

A deposit account is an account from which the depositor cannot withdraw his money before the expiry of a certain period, varying from a few months to several years, as might be agreed upon between him and his bank. The bank, being assured of the use of money thus deposited for a definite period, allows some interest on such deposits—the rate of which depends upon the financial position of the bank and the term for which the money has been deposited.

In the application for a deposit account the customer, in addition to other particulars, has to mention the term for which he intends to keep his money in the bank. In acknowledgment of the receipt of money, the bank issues a deposit receipt which contains the various terms and conditions

upon which the deposit has been accepted. The deposit receipt is a non-transferable document i. e. the value in it cannot be legally transferred to a third party by merely handing it over to him.

On completion of the term of deposit the deposit receipt is surrendered to the bank and the deposit money together with its interest obtained. After the expiry of its term a deposit account may be renewed at the instance of the customer.

The customer can make deposits and withdrawals of money in and from his current account any time he likes. To merchants and business houses this account is a real boon as they have to deposit and withdraw their money very frequently. The bank, however, cannot make the full use of the money deposited in the current account, for it has always to keep at hand a large balance to meet the demand for money which might be made any time and for any amount. Hence, the banks allow very nominal interest or no interest at all on such deposits.

A person opening a current account gets the following from his bank free of charge :

1. A Paying-in-Book
2. A Pass Book
3. A Cheque Book

The paying-in-book contains several small printed forms with counterfoils. These forms are



known as paying-in-slips, credit slips, deposit slips or lodgment docketts. The deposit slips are used for entering the particulars of money *i. e.* cash, notes, cheques, etc., sent by the customer to his bank for crediting it to his account. On receipt of money the cashier of the bank detaches the foil of the deposit slip from the paying-in-book and returns the latter after initialling the counterfoil which serves as a receipt for money.

A pass book is a copy of the account of the customer with his bank. It contains a classified and datewise record of all the entries of deposits, withdrawals and interest. The pass book should be periodically sent to the bank for completing it up-to-date.

A cheque book contains a number of serially numbered printed forms, varying from sixteen to fifty and sometimes even hundred. Each form is made up of two parts, the foil or cheque and the counterfoil, both of which bear the same number. When a cheque is issued, the counterfoil, which is also filled at the same time as the cheque, is retained for future reference. Money from the current account is usually withdrawn by means of cheques. At the end of every cheque book there is a printed form which is utilised for making an application to the bank for the issue of a fresh cheque book.

The savings bank is meant for those who want to keep their money with the bank but do not require to withdraw it very often. The system encourages thrift and saving.

After ascertaining the rules regulating the working of the savings bank account in a bank, the intending customer makes a formal application to the bank and makes his first deposit after filling a deposit slip or credit voucher. The bank then issues him a pass book which is presented with a deposit slip every time a deposit is made. Similarly, if it is desired to withdraw money, a withdrawal form duly filled up, together with the pass book has to be tendered to the bank.

In every bank there is a limit beyond which deposits cannot be made in the savings bank account. Similarly the amount which can be deposited in this account in the course of a year, excluding the withdrawals, is also usually fixed. Nor can the money be withdrawn from this account beyond a certain sum at a time or more than once or twice in a week.

An interest is allowed on these deposits, but its rate is always lower than that which applies to deposit accounts.

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## CHAPTER IX

### BANKERS AND BORROWERS

Banking in theory is subordinate to banking in practice. The theory prescribes the general outline but the details of business always deviate from the paper rules. Nevertheless it becomes necessary to adhere to certain general principles in dealing with a mass of transactions.

A bank usually deals with three classes of borrowers, *viz.* private individuals, partnership firms and public companies.

It is only rarely that private individuals offer bills of exchange for discount. Bills are mainly the by-products of commercial transactions, and private individuals do not generally receive or pay their debts in the form of bills. Bills of exchange coming from private individuals should, therefore, be looked upon with caution, for they may subsequently turn out to be merely accommodation bills without any basis of consideration. Such bills are frequently dishonoured as their acceptors are not often put in sufficient funds to retire them. Furthermore, the style in which a man lives is not always a dependable index of his financial status. The fact that a particular individual keeps up

appearances does not prove that he is rich. Hence, loans should not be given to an individual merely on the strength of his income. Of course, a careful perusal of his banking account might approximately reflect his investments, should the income accruing from the same be periodically passed through his account.

A firm's turnover, *i. e.* the amount of money passing through its account, provides some indication of its solvency. But even here deceptive results are not very unlikely, as the firm in question might be largely buying on credit and selling mainly for cash. Banks sometimes ask the intending firm which wants to borrow money for a short period to furnish a certified copy of its last balance sheet, a proper scrutiny of which reveals the state of its finances to a very great extent. Though in law each partner is an accredited agent of the other members of the firm to an unlimited extent, and he can by his acts, performed in the usual course of business, bind his fellow partners for any amount, it is desirable for the bank, wherever possible, to obtain the consent and authority of all the partners before granting a loan to the firm.

Any person who deals with a company registered under the Companies Act is presumed to have a complete knowledge of the memorandum and articles of association of the company by

which the relations between the latter and any other party are governed. These documents lay down the contractual powers and capacities of the company. It is, therefore, obvious that the bank should inspect these documents and ascertain the borrowing powers of the company before advancing any money to the latter. Again, in the case of newly incorporated companies, it is necessary to see a copy of the certificate for the commencement of business issued by the Registrar, Joint Stock Companies, as no company is authorised to enter into contracts prior to the issue of this certificate. The share-holders of a limited company are not responsible for the liabilities of the company beyond the nominal value of their shares. Short-term advances may, however, be given to the companies only on the strength of joint and several promissory notes signed by at least two directors; but for long-term loans some more substantial and tangible security is usually needed. The debenture holders may have a first charge on the general assets of the company and the bank advancing money to a company for a long time should not fail to ascertain this fact.

Money is borrowed from a bank either by discounting bills of exchange or promissory notes or in the form of cash credits or loans.

When a customer offers certain bills for

discount, the bank should look into his account to see if it warrants the transaction. If, for instance, the bank has been forced to dishonour his cheques on several occasions, it should hesitate in discounting his bills. Nor should the bills from unknown parties or of those whose finances are doubtful be discounted. If the customer's account justifies the transaction the bank has only to see whether the bill is in proper form or not. As most of the bills are accepted payable at some bank it is customary for the discounting bank to enquire about the finances of the acceptor from the bank where the bill has been domiciled. This information is entered into a separate book maintained for that purpose and is treated as confidential.

Cash credit is a kind of loan which banks give to their customers, and which the borrowers are authorised to withdraw from the bank from time to time up to the amount agreed upon, but on which the interest is charged only on each sum withdrawn not from the date of the agreement but from the date of the withdrawal of each sum.

Sometimes a customer is allowed to overdraw his account up to a certain limit when he has to pay interest on the overdraft. It is always safer for the bank to ask for some security for these advances.

When a loan is given, the borrower furnishes

some security in the form of movable or immovable property, and he pays interest on the total amount of money borrowed from the date of the loan. He may transfer the amount of loan to his account and withdraw money out of it from time to time.

These principles only generally guide the transactions between the banker and the borrower, but the personal knowledge of the branch manager of each case outweighs all these iron-clad paper considerations.

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## CHAPTER X

### MONEY MARKET

The money market is the special organisation where the work of supplying credit and capital is carried on. It is not a centralised place but a scattered market. It refers not to an area but to a group of borrowers and lenders of money.

Money market generally deals in short-period loans—usually not exceeding twelve months. The commodity which is dealt within this market is the loanable capital. The borrowers constitute the purchasers of the use of money and the lenders are the sellers. The price at which the use of money is bought and sold is called the rate of interest.

Money market provides a stock of floating funds and facilitates the transference of capital from time to time and place to place according to the conditions of demand and supply, thereby securing stability of prices. Thus, the efficiency of a money market depends upon the extent to which it can supply an efficient currency and regulate its volume according to the needs of industry and trade as also the degree up to which it can mobilise its surplus resources from one section of



the community and transfer it to the other where it can be utilised more efficiently.

The demand for loanable funds comes from business circles and Government for their commercial and financial operations. The supply of money is derived from different banking concerns which in their turn obtain it from the public in the shape of deposits. Competition among the borrowers and lenders settles the rate of interest. When the demand for liquid funds exceeds their supply, the rate of interest rises, and money is said to be dear or tight. Conversely, when the supply of money is larger relatively to its demand, the rate of interest falls and money becomes cheap or easy. In a typical money market the borrowers are the mercantile community, including bill brokers and stock exchange operators, the private individuals, the local bodies and the Government. The lenders are the central bank of the country, the commercial and private banks, the discount houses etc. Frequently the borrowers are also the lenders and *vice versa*. Borrowing in the market takes the form of advances of money on documentary bills, overdrafts, loans and discounting bills of exchange and promissory notes.

The central bank of the country is usually the pivot of the money market, though not infrequently, its interests are antagonistic to those of

## MONEY MARKET

the market. The borrowers are always interested in cheap money but the central bank is often forced to keep it tight and hold its reserves by raising its official rate of discount, commonly known as the bank rate. Beyond the till money required for day to day operations, practically every bank keeps its surplus balance with the central bank, and the latter, by manipulating its rate of discount, regulates the reserves of the country, as also the rate of discount and deposits of other banks. Again, the bank rate is the key by which the central bank regulates the movements of gold to and from the country. Thus, the greater the stringency of money market, the more the influence which the central bank exercises upon the market through the bank rate. But when money is plentiful, its power becomes limited.

The various rates for money prevailing in the money market are :

1. The Bank Rate is the official rate periodically determined by the central bank which it charges for discounting first class short bills.
2. The Market Rate of Discount is the rate of interest charged by other banks for discounting bills.
3. The Loan Rate is the rate of interest which banks charge for short period loans.
4. The Seven Day Rate is the rate of interest

charged by banks for loans given for seven days.

5. The Call Rate is the rate which is charged for loans repayable on demand.

6. The Deposit Rate is the rate of interest allowed by banks on fixed deposits kept with them for different periods.

All these rates are correlated. The bank rate is the axis which turns the entire wheel of the market. All the different rates vary with the bank rate. As the latter goes up, the different rates of interest also rise sympathetically, but the deposit rate falls. Similarly, the converse is also true.

The amount of loanable capital available in the market depends upon numerous circumstances, and the rate of interest is also, therefore, influenced by them. Conditions of trade, political outlook at home and abroad, state of foreign exchanges and conditions of credit—all these factors affect the supply or available funds. Brisk trade makes the money tight and depression makes it cheap. Expectations of war or political uncertainty raise the rate of interest. Similarly, a fluctuating exchange or an unstable credit co-exists with inconsistent value of money. Besides these, there are certain periodic movements which influence the amount of loanable fund in the market. Thus, money becomes cheap when Government dividends

are paid and tight when taxes are realised. Likewise, when the banks issue their balance sheets they call in a large part of their balances from the market to increase their "Cash in hand". This is spoken of as "window dressing" and has the effect of hardening the rates.

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## CHAPTER XI

### BANK RETURN

Bank return is a periodical statement issued by some banks, setting forth their assets and liabilities as on a certain date. The Bank of England, the Reserve Bank and the Imperial Bank of India and almost every central bank of the world issues this statement at regular periods. In its details a bank return resembles the balance sheet of a bank. It is looked upon by financial men as the barometre of the money market, as it enables them to judge the probable trend of tightness or cheapness of money with some amount of correctness.

The subjoined is an imaginary bank return of a central bank :

	Rs.		Rs.
1. Subscribed Capital	11,25,00,000	9. Government securities	29,81,64,000
2. Capital paid up	5,62,50,000	10. Other authorised securities	2,95,36,000
3. Reserve	5,27,50,000	11. Ways and Means advances to Government	.....
4. Public Deposits	20,04,27,000	12. Loans	8,50,48,000
5. Other Deposits	69,64,39,000	13. Cash Credits	99 99 22 000
6. Loans against securities per contra	.....		
7. Contingent Liabilities	.....		
8. Sundries	1,38 99 000		

14.	Inland Bills dis- counted and purchased	3,16,42,000
15.	Foreign Bills discounted and purchased	31,16,000
16.	Bullion	.....
17.	Dead stock	2,83,80,000
18.	Liabilities of consti- tuents for contingent liabilities per <i>contra</i>	.....
19.	Sundries	46,91,000
20.	Balances with other banks	9,53,000
		<u>71,14,63,000</u>
21.	Cash	<u>30,82,32,000</u>
22.	Percentage	23.84
23.	Bank Rate	5 per cent

Rs. 101,96,95,000Rs. 101,96,95,000

Let us attempt to interpret each of the terms occurring in the above return :

*Liabilities* :—

1. **Subscribed Capital**—This represents the total amount of capital which the shareholders of the bank have agreed to take up.

2. **Capital paid-up**—This is the amount which has been actually paid by the shareholders on their shares. The difference between the subscribed capital and paid-up capital represents the reserve capital.

3. **Reserve**—This denotes the amount set aside out of the profits of the bank for strengthening its finances and for various contingencies.

4. **Public Deposits**—These are the deposits kept with the bank on Government account.

5. **Other Deposits**—Under this head are included all kinds of deposits (*i. e.*, fixed, savings bank and current account) of the public and of different banks.

6. **Loans against Securities per contra**—These indicate the amount of money borrowed by the bank on the security of investments appearing on the assets side of the return.

7. **Contingent Liabilities**—These represent the liability of the bank as a surety for acceptances and endorsements given by it on behalf of its customers who appear as debtors to the same

extent on the assets side of the return. In the case of contingent liabilities, the liability of the bank arises only when the customers, on whose account acceptances and endorsements have been given, fail to honour their bills.

8. Sundries—These are other liabilities and funds of the bank.

*Assets :—*

9. Government Securities—These are the investments of the bank in Government securities.

10. Other Authorised Securities—These represent the investments of the bank in various authorised securities other than Government securities.

11. Ways and Means Advances—These indicate short period loans given to the Government.

12. Loans—These are monies lent to the public and different banks.

13. Cash Credits—These represent the loans on cash credit.

14. Inland Bills Discounted and Purchased—These are inland bills of exchange discounted by the bank.

15. Foreign Bills Discounted and Purchased—These are foreign bills of exchange discounted by the bank.

16. Bullion—This amount represents the



stock of precious metals purchased by the bank.

17. **Dead Stock**—This amount represents the fixed assets of the bank.

18. **Liability of constituents for contingent liabilities per *contra***—This represents the acceptances and endorsements of bills given by the bank on behalf of its customers who are liable to the bank for the necessary amounts of their bills should they fail to meet them when they mature. The amount, therefore, also appears on the liabilities side of the return.

19. **Sundries**—These include other assets of the bank not separately specified.

20. **Balances with other Banks**—These refer to monies deposited with different banks.

21. **Cash**—This indicates the amount of "cash in hand."

22. **Percentage**—It shows the proportion of cash to outside liabilities (excluding capital and reserve).

23. **Bank Rate**—This is the official rate charged by the bank for discounting first class short bills.

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## CHAPTER XII

### CHEQUES

A cheque is a written unconditional order from a customer to his banker to pay on demand a certain sum of money to, or to the order of, a certain person, or to bearer.

The customer who draws the cheque is known as the drawer, the bank on which it is drawn is the drawee and the person to whom payment is to be made is called the payee of the cheque. If the payee wants to transfer the property in the cheque to some other party, he negotiates it by endorsement and becomes the endorser, and the transferee of the cheque is called the endorsee.

Cheques are negotiable instruments. A negotiable instrument is one the property in which is transferred to a holder in due course by mere delivery or by endorsement and delivery, notwithstanding the defective title of the transferer. A holder in due course is a person who, in good faith and for consideration, takes a negotiable instrument complete and regular on its face before the amount mentioned in it becomes payable, and without any reason to believe that any defect exists in the title of the person from whom he gets it. In spite

of the defective title of any of the previous parties the holder in due course acquires a good title to the instrument. This protection is, however, not available to a holder who is only in physical possession of the instrument.

Cheques are of two kinds, *viz.*, bearer and order. A bearer cheque is that in which the words "or bearer" are added after the name of the payee, who can then negotiate it by mere delivery. A bearer cheque can be encashed by any holder at the counter of the bank upon which it is drawn. An order cheque, on the contrary, can only be transferred by endorsement and delivery, and the payee of it can have it cashed only after endorsing it.

In drawing a cheque the following things deserve particular attention :

1. Date—The drawer should mention the date on which he draws the cheque. A cheque which bears a date previous to that on which it is drawn is called an ante-dated cheque. On the other hand, a cheque is post-dated if it is dated forward when it cannot be paid before the date mentioned. An undated cheque does not contain any date, and any person can enter in it a date which he considers to be correct. But a bank generally refuses to pay an undated cheque.

2. Name of the payee—The drawer should

clearly mention the name of the payee in the place provided for it. Should he like to withdraw money for himself, he should make the cheque payable to "self."

3. Order or bearer—The suffix "or order" to the name of the payee makes the cheque payable to his order, and it cannot, therefore, be negotiated without his endorsement. When, on the other hand, the expression "or bearer" is added after the payee's name, the cheque can be encashed by any person presenting it at the counter of the drawee bank. A cheque in which none of the expressions, "or order" or "or bearer" appears, is treated as an order cheque. Sometimes the payee of a cheque is some fictitious person as Robinson Crusoe when the instrument becomes a bearer cheque. Any person can make a bearer cheque into order, but no party, other than the drawer, can convert an order cheque into one payable to bearer.

4. Amount—Great care should be taken in filling up the amount. It is mentioned twice—once in words and again in figures. If the words and figures of a cheque show different amounts, it is returned unpaid by the bank. To avoid chances of forgery, the words and figures should be closely written and no blank space should be left either before or after them.

5. Drawer's signature—When signing the

cheque the drawer should see that his signature is exactly similar to the specimen he has given to his bank. Banks are expected to recognise the signatures of their customers, and if they pay a forged cheque they are liable for it. But a bank is not responsible for forged endorsements.

6. Completing the counterfoil—Before parting with the cheque the drawer should always fill up the counterfoil wherein all the above particulars are entered.

The following is a facsimile of a cheque :—

Counterfoil.	Cheque.
No. AC 7111.	No. AC 7111.
Date 11th Aug. 1936.	Lucknow, 11th Aug., 1936.
In favour of A. B. C.	The Central Bank of India, Ltd.
Rs. Five Hundred only	Pay A B C.....or Order.
Rs. 500/-/-	Rupees Five Hundred only....
X Y Z.	Rs. 500/-/-
	X Y Z.

When the payee of a cheque signs his name at its back with a view to negotiate it he is said to endorse it. Every order cheque requires the endorsement of the payee, but a bearer cheque may be negotiated without any endorsement.

If the endorser simply signs his name at the back of the cheque without mentioning the name

of the party to whom he negotiates the cheque, the endorsement is said to be "in blank." On the contrary, if he mentions the name of the endorsee with or without the words "or order," the endorsement is "in full." A blank endorsement has the effect of making the cheque payable to bearer, and its further negotiation depends merely on delivery of the instrument. But a cheque endorsed in blank may subsequently be endorsed in full when it again becomes payable to the order of the endorsee.

A cheque with partial endorsement (*i. e.* when only a part of the amount of the cheque has been made payable) is invalid for negotiation. Similarly, a conditional endorsement operates against the negotiability of the cheque and becomes void.

If a cheque has been endorsed by a person who dies before delivering it to any party, it cannot be negotiated by his executors or administrators without re-endorsing it in their respective legal capacities.

When the endorser prohibits any further negotiation of the cheque, or restricts the endorsee to deal with it in the manner directed by him in the endorsement, the endorsement becomes restrictive.

A facultative endorsement is that in which the endorser makes it clear that the subsequent

parties should not look to him for payment of the instrument should it be dishonoured. This is done by adding the words "Sans Recours" or "Notice of dishonour waived."

The endorser must sign his name exactly as it appears in the cheque. If his name has been incorrectly spelt, he should first write the same spelling and then his correct signature just below it. In an endorsement all titles of courtesy *e. g.* Mr., Dr., Babu, Lala, Thakur, Munshi, Pandit, M. A., M. B., B. S., etc. are omitted. The word 'Shrimati' is a recognised prefix to the names of the Hindu ladies, and the latter can make it a part of their signatures. A lady should endorse her name according as it appears on the cheque and then add the expression "Mrs." or "wife of Mr..." after her signature. An illiterate person should endorse a cheque by putting his thumb impression which should be attested by a witness whose address together with the name of the endorser must appear with the endorsement. An endorsement in which the signature is in pencil or by an India rubber stamp, though not illegal, is refused by banks.

Endorsements on behalf of firms and companies deserve special attention. A partner is virtually an unlimited agent of his fellow partners, and he can endorse a cheque on behalf of his

firm. Contrary to this, cheques payable to a joint stock company are endorsed by some of its officials who should explicitly mention in the endorsement the legal capacity in which they are endorsing. This might be done by adding some such term as "for" or "for and on behalf of" etc. before the name of the company followed by the signature and official designation of the person who is endorsing. Where a power of attorney has been given to certain official, he should put the words "Per Pro" or the letters "P. P." (meaning per procuration) before the name of the company and then sign his name. In this case it is not essential to add the official designation, because the bank, accepting a "per pro endorsement," is deemed to have satisfied itself about the legal powers of the endorser.

No agent can employ another agent without the previous consent of the principal for endorsing the cheques of the latter. A trustee cannot sign for other trustees, hence endorsements by trustees must be signed by all. But an executor can sign on behalf of other co-executors. When a company goes into liquidation its officials cannot legally sign for it, as the virtual ownership of the concern then vests in the liquidators who endorse on behalf of the company in their official capacity. One liquidator can sign on behalf of another liquidator



of the same company.

The following specimens illustrate these different kinds of endorsements:—

1. Blank Endorsements:—
  - (a) A. Smith.
  - (b) Pay to Mr. John James or bearer.  
A. Smith.
  - (c) Pay to Robinson Crusoe.  
A. Smith.
2. Full or Special endorsements:—
  - (a) Pay to Mr. John James or order.  
A. Smith.
  - (b) Pay to Mr. John James.  
A. Smith.
3. Restrictive endorsements:—
  - (a) Pay to Mr. John James only.  
A. Smith.
  - (b) Pay to Mr. John James or order  
for collection.  
A. Smith.
4. Facultative endorsements:—
  - (a) Pay to Mr. John James or order.  
Sans Recours.  
A. Smith.
  - (b) Pay to Mr. John James or order.  
Notice of dishonour waived.  
A. Smith.

5. Endorsement where payee's name has been mis-spelt :

A. Smithe.  
(A. Smith).

6. Other Endorsements:—

- (a) A. Smith (Dr.).  
(b) A. Smith (M. D.).  
(c) Ellenor Smith.  
    Wife of Dr. A. Smith.  
(d) Shrimati Brij Kishori Devi.

7. Endorsement by an illiterate person:—

Ram	Thumb Impres- sion	Din.
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Witnessed by—

A. Smith,  
24, Lombard Street,  
London.

8. Endorsements on behalf of Partnership firms:—

- (a) For Smith Bros.,  
    A. Smith,  
    Partner.  
(b) Smith Bros.

9. Endorsements on behalf of companies:—

- (a) For Smith Bros. Ltd.,  
    A Smith,  
    Secretary.

(b) Per Pro. Smith Bros. Ltd.

A. Smith.

10. Endorsement by trustees:—

A }  
B } Trustees.  
C }  
D }

11. Endorsement by an executor:—

For self and Co-executors of  
John James.

A. Smith.

12. Endorsement by a liquidator:—

For Smith Bros. Ltd. in liquidation.

A. Smith,  
Official Liquidator

When the back of a cheque becomes full so that further endorsements cannot be made upon it, any endorser may paste to it a slip of paper for bearing subsequent endorsements—he himself signing a part of his name on the cheque and the remaining on the slip attached. This slip is called allonge.

If a cheque, after changing several hands, comes again to the drawer, he may treat it as cancelled. This is known as circuity of action of the cheque.

A crossed cheque is one on the face of which two parallel transverse lines with or without the words "& Co" appear. An uncrossed cheque is called "open cheque." Crossed cheques are pay-

able only through a bank and cash cannot be had for them on demand. Crossing makes the cheque more secure as it cannot be paid to a wrong party. It is advisable to cross all cheques to be sent through post.

When a crossing is made without the name of any bank, it is called general crossing. But if the name of a bank is mentioned, it becomes a special crossing, and in that case the cheque can be paid through that bank only.

Below are given a few specimen crossings of cheques:—

**General Crossings.**

1.	2.	3.	4.	5.
	& Co.	Not Negotiable	& Co. Account Payee Only.	Under Rupees Ten Only.

## Special Crossings.

6.	7.	8.	9.	10.
Imperial Bank of India.	& Co. Central Bank of India Ltd.	Not Negotiable Allahabad Bank Ltd.	Account Payee Only Punjab National Bank Ltd.	Under Rupees Ten Only Peoples Bank of Northern India Ltd.

The words "not negotiable" appearing in the crossing of a cheque do not in any way restrict its negotiability. It simply implies that the person who accepts such a cheque cannot claim a better title to it than that of the person from whom he receives it. If the title of the transferrer is defective the title of the transferee also becomes defective. Thus, if a person takes a stolen cheque with "not negotiable" crossing, he may have to make good the loss to the owner of the instrument. The phrase "not negotiable", therefore, means

nothing more than the note of warning to the transferee: "Be careful of the transferrer". If the words "account payee only" form part of the crossing, the cheque can be collected only for the account of the payee. The mention of the words "Under Rs....." merely prohibits the drawee bank to pay more than the amount named, thus obviating any chances of altering the amount of the cheque beyond that sum.

Any holder may cross an open cheque or convert a general into special crossing; but only the drawer can cancel the crossing or alter the special crossing into general after initialing the alteration. Similarly, every material alteration in the cheque must be supported by the signature of the drawer.

When a cheque has been lost, notice of it should be given forthwith to the drawer with a request to re-issue another cheque and to stop the payment of the lost cheque. If after the receipt of instructions of the drawer to stop the payment the cheque is paid, the bank is liable for the amount. A cheque which is torn is known as mutilated cheque, and it is generally refused by the bank unless it bears the signature of the drawer with such words as "accidentally mutilated by me". Similarly, a cheque which is more than six months old from the date of its issue becomes "stale" and

is returned unpaid by the bank.

When upon presentation the drawee bank pays the cheque, it is said to be honoured. On the other hand, if the payment is refused, it is dishonoured. A cheque is "marked" when it is returned by the paying bank with reasons of non-payment duly mentioned on it. A cheque may be returned marked when:

1. Words and figures differ.
2. Endorsements are irregular.
3. Post-dated cheque is presented before the date named.
4. Stale cheque is presented.
5. Cheque becomes mutilated.
6. On account of certain reasons the bank refers the holder to the drawer.
7. Effects are not cleared.
8. The drawer has insufficient funds at his credit.
9. The drawer stops payment.
10. The drawer has closed his account.
11. The bank wants the cheque to be presented again.
12. Payee's signature requires confirmation.
13. The cheque is drawn without arranging any credit.
14. Garnishee order has been issued by the court.

15. The drawer becomes insolvent.
16. The drawer becomes insane.
17. The drawer has died.
18. The drawer's signature differs.
19. The drawer has no account.

When a cheque has been dishonoured, notice of it should be immediately given to the drawer and all previous endorsers, if the holder wants to hold them liable on the cheque failing which the liability of the previous parties except that of the drawer of a cheque is liable to all the endorsers, and every endorser is responsible to subsequent endorsers.

Cheques considerably minimise the use of other expensive media of exchange, as a large number of credit transactions are cancelled through the intervention of these instruments. But if all cheques were paid in cash by the paying bankers there would be considerable trouble, inconvenience and useless transfer of currency from one bank to the other. The system of cancelling mutual obligations, arising on account of cheques among different banks in big cities, through clearing houses, obviates these disadvantages.

A clearing house is a central organisation of banks where the mutual obligations of the constituent members in the form of cheques are cancelled. Under this system every clearing bank is a



member of the clearing house which is generally situated in, and controlled and managed by some well-established bank, usually the central bank of the country. At the close of every day each bank has some cheques drawn on the other banks, while the other banks have some cheques drawn on it. These debits and credits of each of the banks upon the others are cancelled through the "Banks Clearing Account", which is always a balanced account. Every clearing bank has to maintain an account with the bank where the clearing house is situated.

The following illustration explains the working of the clearing house system:—

Let us assume that there are three banks A, B and C in a clearing house. Suppose that :

The bank A has cheques { the bank B for Rs. 10  
drawn on { " " C " Rs. 50

The bank B has cheques { the bank A for Rs. 70  
drawn on { " " C " Rs. 50

The bank C has cheques { the bank A for Rs. 100  
drawn on { " " B " Rs. 50

Now A has to receive Rs. 60 { but it has to  
pay Rs. 170  
B " " Rs. 120 " " Rs. 60  
and C " " Rs. 150 " " Rs. 100

The accounts will appear thus:—

A			
	Rs.		Rs.
To B	10	By B	70
" C	50	By C	100
" Banks' Clearing Account	110		
	Rs. 170		Rs. 170

B			
	Rs.		Rs.
To A	70	By A	10
" C	50	" C	50
		Banks' Clearing Account ..	60
	Rs. 120		Rs. 120

C			
	Rs.		Rs.
To A	100	By A	50
" B	50	" B	50
		" Banks' Clearing Account ...	50
	Rs. 150		Rs. 150

## Banks' Clearing Account

		Rs.		Rs.
To	B	60		By
	" C	50		A
		110		
		110		
				110
				110

Thus, the obligation of each of the banks is cleared through the medium of the Banks' Clearing Account without any intervention of money.

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## **CHAPTER XIII**

### **BILLS OF EXCHANGE**

A bill of exchange is an instrument, containing an unconditional order in writing, addressed by one person to another, signed by the person making it, directing the person to whom it is addressed to pay on demand or at a fixed or determinable future time a certain sum of money to or to the order of a certain person or to the bearer of the instrument.

The maker of the bill is called the drawer, the person on whom it is drawn is known as the drawee and the person to whom payment is to be made is the payee of the bill. A bill is called a draft before it is accepted, but when the drawee accepts it, it becomes an acceptance, and the drawee is called the acceptor.

A bill has many advantages. It is a legal evidence of debt and fixes the date of payment. As it is a negotiable instrument, the holder can negotiate it in settlement of his indebtedness. As a safe, easy and cheap means of remitting money, it obviates the necessity of transferring bullion and coins from one place to another. It is a convenient representative of money and the holder

can cash it any time by discounting it with a banker.

Like other negotiable instruments, a bill of exchange is presumed to stand on valuable consideration. The consideration must be lawful. It is, however, not necessary that the consideration must be sufficient so long as it exists.

A trade bill is a bill of exchange which is drawn and accepted for value in the ordinary course of business. In contradistinction to it, an accommodation bill is one which is drawn, accepted and negotiated without any consideration but simply to oblige a party and to enable him to raise money by discounting it. Accommodation bills are called fictitious bills, "kites", "wind mills" etc.

Bills of exchange are of two kinds, *viz.* inland and foreign. An inland bill is that which is drawn in one country and made payable in, or drawn upon a person resident in the same country. Any other bill is a foreign bill. Again, a bill may be short or long according to the length of its tenor.

The drawer of a bill should pay attention to the following points :

1. *Date*—This should be carefully entered as the due date of a bill payable "days", or "month after date", *e.g.* "thirty days after date" or "three months after date is calculated from the date" of the bill.

2. *Term*—Term, tenor or currency of the bill refers to the period for which it is drawn. A bill may be payable (i) so many days or months after date; (ii) so many days or months after sight; or (iii) on demand, at sight or upon presentation. In the first two cases the bill does not mature unless after the expiry of the term mentioned and three extra days called the “days of grace”. Bills payable on demand have no days of grace.

3. *Amount*—This is mentioned twice, once in words in the body of the bill and again in figures at the left-hand top corner.

4. *Parties*—The name of the payee is mentioned in the body of the bill and that of the drawee together with his address is generally given at the left-hand bottom corner—the drawer of course signing the instrument at the end in the lower right corner. Sometimes the drawer adds the name and address of a referee in case of need to whom the holder may approach for acceptance or payment of the bill should it be dishonoured by the acceptor. This is mentioned thus: “In case of need apply to X Y Z, Curzon Circus, Hamburg”.

5. *Stamp*—An *ad valorem* stamp duty at the scheduled rate of the Stamp Act is charged on all bills other than those payable on demand.

6. *Value received*—This is a customary ex-

pression which is included in the bills of exchange. It only denotes that the instrument has been drawn for consideration.

The following is a specimen of an inland bill of exchange :

No Ac. 1950  
Rs. 500-0-0

Calcutta, August 11, 1936.

Stamp 6 Annas	Three months after date pay to Messrs. Allenbury & Co. Ltd., or order, the sum of Rupees Five Hundred only, value received.
---------------------	--

Per Pro. Smith & Sons Ltd.  
*A. Smith,*  
 Secretary.

To

Messrs. Allan George & Co., Ltd.,  
 Esplande,  
 Bombay.

A foreign bill of exchange is drawn in one country and made payable in, or drawn upon a person resident in another country. Foreign bills are drawn in sets of two or three—each part being called a *via*. Every part of the set is numbered and refers to the other. All the *vias* of a set are posted through different mails, so that if one of

them is lost the other may reach the drawee. As soon as a part of the set is paid the others become void. A bill which is drawn singly is known as sola bill. Foreign bills of exchange are stamped twice—once in the country of the drawer and again in the country of the acceptor. But only one copy of the set is stamped.

The customary period for which foreign bills of exchange are drawn between one country and another is called usance. It is determined by distance, facility of communication and custom of trade between the countries concerned. The usance between India and England is sixty days after sight.

Below is an example of a set of a foreign bill of exchange:

### First of Exchange

Bombay, 11th August, 1936.

Stamp
15
Annas

Exchange for Rs. 900-0-0

£ 60

Sixty days after sight, pay this First of Exchange (Second and Third of the same tenor and date unpaid) to the order of Sir Isaac Pitman and



Sons Ltd., the sum of sixty pounds sterling, value received and charge to account as advised.

For Commercial Book House Ltd.,

*A. Smith,*

General Manager

To,

Messrs. Grant & Sons Ltd.,

Brodway,

London, W. C. 2.

**Second of Exchange**

Bombay, 11th August, 1936.

Stamp 15 Annas
----------------------

Exchange for Rs. 900-0-0

£. 60

Sixty days after sight, pay this Second of Exchange (First and Third of the same tenor and date unpaid) to the order of Sir Isaac Pitman and Sons Ltd., the sum of sixty pounds sterling, value received and charge to account as advised.

For Commercial Book House Ltd.,

*A. Smith.*

General Manager.

To,

Messrs. Grant & Sons Ltd.,

Brodway,

London, W. C. 2.

**Third of Exchange**

Bombay, 11th August, 1936.

Stamp 15 Annas
----------------------

Exchange for Rs. 900-0-0

£. 60

Sixty days after sight, pay this Third of Exchange (First and Second of the same tenor and date unpaid) to the order of Sir Isaac Pitman and Sons Ltd., the sum of sixty pound sterling, value received and charge to account as advised.

For Commercial Book House Ltd.,

*A. Smith,*

General Manager.

To,

Messrs. Grant &amp; Sons Ltd.,

Brodway,

London, W. C. 2.

Documentary bills are those foreign bills of exchange to which certain documents of title, such as invoice of goods, bill of lading, insurance policy, letter of hypothecation, dock warrant, delivery order, ware-house-keeper's certificate etc. are attached. The bill may be drawn "documents against acceptance" (D/A) or "documents against payment" (D/P). In the former case the documents of title are surrendered to the acceptor on

his accepting the bill, and in the latter case only when he pays it. If the acceptor retires the bill before its due date a rebate is generally allowed to him.

Here is an example of a documentary bill:—

No. Ac 1007

Calcutta, 11th August, 1937.

Stamp
15
Annas

Exchange for Rs. 900-0-0

£ 60

Sixty days after sight, pay this First of Exchange (Second and Third of the same tenor and date unpaid) to our order, the sum of sixty pounds sterling, value received against 



 100-4-5 packages of books per S. S. *Hindustan*. Documents attached to be surrendered on payment.

For Commercial Book House Ltd.

*A. smith,*

General Manager.

To,

Messrs. Grant & Sons Ltd.,

Brodway,

London, W. C. 2.

Acceptance of a bill means the signification of assent by the drawee or his authorised agent to the order of the drawer. This is done by drawee's

putting his signature across the face of the bill with or without the word "accepted." Sometimes the acceptor adds to his acceptance the name of the bank where the bill is to be paid (this is known as domicile of the bill). The date of accepting the bill should also be mentioned in the acceptance. This is specially needed when the bill is drawn payable "days or months after sight", because its due date in that case is calculated from the date of acceptance.

An acceptance may be general or qualified. A general acceptance assents to the order of the drawer without any qualification. The mention of the domicile of the bill in the acceptance does not, however, alter its character. A qualified acceptance, on the other hand, expressly varies the effect of the bill as it is drawn. The qualification may be.

- (i) Conditional *e. g.* When the bill is "accepted on condition of two month's renewal".
- (ii) Local *e. g.* When the bill is "accepted payable at the Imperial Bank of India and there only".
- (iii) Partial *e. g.* When the bill for Rs. 1,000 is "accepted for Rs. 500 only".

- (iv) Periodical *e. g.* When the three months' bill is "accepted payable after six months only".
- (v) Partial as to acceptance *e. g.* Acceptance by some but not by all the drawees *e. g.* A bill, drawn on A, B and C, is accepted by A and B only.

The holder of a bill may refuse to take a qualified acceptance and treat the bill as dishonoured by non-acceptance. But once he takes a qualified acceptance the liability of the drawer and previous endorsers ceases. A qualified acceptance, however, binds the acceptor to the subsequent endorsers.

The holder should present the bill for acceptance before the due date to the drawee or his duly authorised agent at his usual place of business, or residence, or some other specified place during usual business hours. If there are two or more drawees the bill should be presented to all of them unless one of them is authorised to accept on behalf of others when it should be presented to him only. If the drawee has died the bill should be presented to his legal representative. When the drawer becomes insolvent presentment should be made to his trustees.

Presentment through post is considered regular unless there is an agreement to the contrary or it is not authorised by usage. The drawee is authorised to retain the bill for 24 hours before giving his acceptance.

Presentment is excused when the drawee is dead, bankrupt, a fictitious person or a person without contractual capacity. It is also excused if the drawee cannot be traced even after the exercise of reasonable diligence.

Like cheques, bills of exchange are also endorsed and negotiated.

A bill of exchange must be duly presented for payment by the holder to the acceptor, failing which the responsibility of the drawer and all other previous endorsers ceases. Bills payable on demand should be presented within reasonable time, whereas other bills become due for payment as they mature, when they should be presented to the acceptor or his authorised agent during regular business hours at his place of business, residence, or any other specified place. Unless against usage or any agreement to that effect, presentment through post is considered to be regular. Delay in presentation for payment is excused if it is caused by circumstances beyond the control of the holder. It is also excused if the drawee is a fictitious person, or if even after the exercise of

proper diligence he cannot be found.

When a bill of exchange is dishonoured either by non-acceptance or non-payment, immediate notice of it must be given to the drawer and all the endorsers. Failure to do so discharges them from their obligation. Each party receiving the notice of dishonour should give similar notice to all the antecedent parties. When, however, the drawer or any of the endorsers has mentioned the name of a "referee in case of need" the holder may approach him for acceptance or payment after giving the notice of dishonour to the parties liable on the instrument.

The acceptor is the person primarily liable on the bill, but his obligation does not begin until after he has accepted it. The acceptor is liable only to the drawer before giving his acceptance and to the drawer and all other endorsers after he has accepted the bill. The drawer is liable to all the endorsers, and each endorser is liable to the subsequent parties.

When a bill has been dishonoured by non-acceptance or non-payment it should be noted. Noting of a bill constitutes the presenting of a dishonoured bill by the Government official, called Notary Public, to the drawee or acceptor and demanding acceptance or payment of the same. A bill must be noted on the date of its dishonour.

The Notary Public certifies on a slip of paper, called noting ticket, that he presented the dishonoured bill to the drawee and that it was even then not accepted or paid. This is accepted as an official proof of dishonour of the bill. The noting ticket is attached to the bill. Here is an example of noting ticket.

Alfred Smith,  
Notary Public,  
The Mall, Lahore.  
Noting charges Rs. 5.  
Refer to Acceptor.

All inland bills of exchange should be noted when they are dishonoured. But foreign bills also require protesting in addition to noting. This is done with a view to secure the rights and claims of the holder against the drawer and the endorsers, all or any one of whom might be living in the foreign country. A protest is a solemn declaration made by the Notary Public that he presented the dishonoured bill for the second time, that his demand was met by the reply as stated in the protest, and that he formally protests against the refusal of the demand. The protest is attached to the bill along with the noting ticket. Below is given an illustration of a protest:—

KNOW all that I, Alfred Smith of Lahore in the country of India, at the request of Mr. Thomas



George, did on the 11th day of August, 1936, at 5, College Square, Calcutta, demand payment of the bill of exchange herewith attached, from Mr. Allan Unwin, to which demand he made answer—No Funds—whereof I know, in the presence of Mr. Gadgill Foster and Mr. Vivian Liddle do protest the said bill of exchange.

*Alfred Smith.*

August 11, 1936.

*Gadgill Foster.*

*Vivian Liddle.*

} witnesses

Over and above the amount of the bill, the holder of a dishonoured bill can recover from the party liable on it the interest of the amount from the date of presentment if it is a demand bill, or from the date of maturity in case of other bills, and the expenses of noting and protesting.

When a bill has been noted and protested and before it is overdue, any person, not being a party liable on it, may intervene, and with the consent of the holder, he may accept it supra protest if it has been dishonoured for want of acceptance, or pay it supra protest if it has been dishonoured on account of non-payment, for the honour of any of the parties liable on the instrument. The acceptance for honour supra protest must be written on the bill itself, and it should state the name of the party for whose honour it has been accepted. It must

be signed by the acceptor for honour. Here is an example of an acceptance for honour :—

Accepted for the honour and on account of Messrs. Allan Unwin & Co. with £ 0-7-0 noting charges and expenses.

*Alfred Smith.*

If no party for whose honour the bill has been accepted is expressly mentioned, it is deemed to be for the honour of the drawer. After a person has given his acceptance for honour supra protest he becomes liable on the bill to all the subsequent parties.

Any material alteration in the bill must be initialled by the person who alters it, for a bill of exchange, which has been materially altered, releases all the parties to it from their liability except the person who alters it and those who are subsequent to him. An alteration in the date, amount, time or place of payment of the bill is taken as a material alteration.

If a holder has lost his bill, he should apply to the drawer for the reissue of another bill of the same tenor and amount after giving an undertaking, if required, to indemnify him against all losses arising on account of the lost bill.

Forgery gives no title. A holder acquires no title to a bill which bears a forged signature either of the drawer, or acceptor, or endorser in spite of

the fact that he has no knowledge of the forgery. But he can demand repayment of the money he has paid for the bill to the transferrer.

A bill is discharged by payment in due course, by circuitry of action, when it is negotiated to the acceptor himself, or when the holder renounces his rights against the acceptor, or when it is materially altered without the consent of the acceptor.

Another important negotiable instrument which resembles a bill of exchange is a promissory note. A promissory note is an unconditional promise in writing, signed by the person making it, undertaking to pay on demand, or at a fixed, or determinable future time, a certain sum of money to, or to the order of a certain person, or to bearer.

The maker of a promissory note is called the promisor and the payee is the promisee.

A promissory note may be joint, several or joint and several. When the makers of the promissory note promise to pay it jointly, it is called a joint promissory note; but when they agree to pay it severally, they are individually liable upon it. On the other hand, if they undertake to pay it jointly and severally, they are liable both in their joint capacity as well as individually. The following examples illustrate these types of promissory notes:

**Joint Promissory Note**

Calcutta, 11th August, 1936

Stamp 9 Annas
---------------------

Rs. 500/-/-

One month after date we promise to pay Messrs. Thacker Spink & Co. Ltd. or order the sum of rupees Five Hundred only, value received.

*Alfred Smith.**Robert Smith.***Several Promissory Note**

Calcutta, 11th August, 1936.

Stamp 3 Annas.
----------------------

Rs. 100/-/-

Three months after date I promise to pay The Calcutta Book Company Ltd. the sum of Rupees One Hundred only, value received.

*Alfred Smith.**Robert Brown.***Joint and Several Promissory Note**

Rs. 50/-/-

Calcutta, August 11, 1936.

On demand we jointly and severally promise to pay The Calcutta Book Company Ltd. the sum of Rupees Fifty only, value received.

*Alfred Smith.**Robert Smith.*

A promissory note differs from a bill of exchange in the following respects :—

1. In a bill of exchange the drawer and the drawee are different parties, but in a promissory note the same person is the drawer and the promisor.

2. A bill of exchange is an order from the drawer to the drawee, but a promissory note is a promise by one party to the other.

3. A bill of exchange is drawn by the creditor, but the maker of a promissory note is a debtor.

4. A bill of exchange requires an acceptance, but a promissory note does not.

5. The acceptor of a bill of exchange cannot be liable jointly with another acceptor, but the makers of a joint promissory note are liable upon it in their joint capacity.

6. Foreign bills of exchange are drawn in sets of two or three. This is not the case with foreign promissory notes.

7. Dishonoured foreign bills require noting and protesting, while foreign promissory notes do not.

An I. O. U. is a written acknowledgment of a debt. It owes its name to the letters I. O. U. because each of the words of the expression I Owe You commence with these letters and have the same sound as the letters. An I. O. U. runs as follows:—

To Mr. George Gadgill, I. O. U. Fifty Rupees.

*Alfred Smith*, 11th August, 1936.

An I. O. U. does not require any stamp. It is nothing more than an evidence of account stated with the creditor if his name is given, otherwise it is taken to be the evidence of account stated with its holder. I. O. Us. are not negotiable.

A bank draft is a bill of exchange drawn by one banker upon another, requesting the banker to whom it is addressed to pay (generally on demand) a certain sum of money to, or to the order of the person named. Bank drafts do not require any acceptance. They are paid by the drawee bank on presentation. A small commission is charged on inland drafts but in the case of foreign drafts this is covered by the rate of exchange at which they are purchased. One who intends to remit money by means of a draft has to fill in a form and hand it over together with the amount and commission at the counter of the bank on receipt of which the banker draws and signs the draft required. This is sent in due course to the payee.

Bank post bills are short term bills drawn by one branch upon another branch of the same bank and issued free of charge to the public. The Bank of England issues these bills for any sum from £10 to £1,000 at 7 or 60 days after sight. Bank post bills are not subject to any days of grace. They provide an easy and convenient means of

remitting money from one part of the country to another.

A letter of credit is a document addressed by a banker to his agent or correspondent abroad, requesting him to pay to the bearer a particular or an unlimited sum of money on the credit of the writer. The letter of credit contains the time for which it remains current as also the signature of the party to whom it is given. It is desirable that a letter of advice giving full particulars of the credit issued should be sent to the agent or correspondent to whom the letter of credit has been addressed.

When the letter of credit is addressed to several agents or correspondents in different foreign towns it is called a circular letter of credit. The banker making a payment against a circular letter of credit endorses upon it the amount he has paid and all subsequent payers do the same thing till the whole amount of credit for which the document has been issued is paid.

While a bill of exchange is an order, a letter of credit is a request. A letter of credit, unlike a bill of exchange, requires no acceptance. It is not a negotiable instrument. Nor does it require any noting and protesting for non-payment.

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## CHAPTER XIV

### BANKER AND CUSTOMER

The general relationship of a banker to his customer is that of a debtor to his creditor, but the manifold duties of the former towards the latter make the legal relation very complex.

As a debtor to his customer, the position of a banker differs from that of ordinary debtors. A banker, for instance, is not bound to pay back to his customer the same coins and notes which he has deposited with him. Similarly, a banker can deal with the money deposited with him in any manner he likes.

In the absence of any agreement to the contrary, the banker has a right to combine the different accounts standing in the name of the same person and to transfer the balance from one to the other, provided the accounts are maintained in the same right.

A banker is not a trustee to his customer, otherwise he would have to account for all profits made by him in respect of his customer's money deposited with him.

The application of the statute of limitation in the case of debts between a banker and his custo-



mer is different from other debts. Ordinarily, a creditor cannot recover his money from his debtor after the lapse of a certain time when the debt becomes time-barred, but in the case of money deposited with a bank the statutory time is reckoned not from the date of deposit but from the time the payment is demanded. Thus, though the law operates, its application is less rigorous in practice.

A banker is a bailee to his customer in respect of all valuables and securities deposited with him for safe custody. If the banker does not make any charge for keeping these things, he is a gratuitous bailee; and provided he acts in good faith and takes reasonable precaution, he is not responsible for any loss of or damage to the goods. On the contrary, if he charges a commission, he is, like any other bailee, liable for the loss of goods.

In his capacity as a banker, a banker has general lien over all the securities of his customer coming into his possession in the usual course of business. This general lien is a legal right to retain possession of the valuables and securities of the customer until all debts due by the latter have been discharged. The general lien, however, does not attach to valuable securities deposited with the banker for safe custody. Along with the general lien there is also an implied right of sale; and a banker is

authorised to recover his debts and dues from the customer by selling his goods over which the general lien extends.

The banker stands as a trustee or agent to his customer in respect of all subscriptions and premiums he undertakes to pay periodically for the latter and of all interests and dividends he agrees to collect for him. If he neglects in his duties he is responsible for any loss to his customer.

A banker, opening a current account with a person, undertakes to repay his amount in such parts as he may direct him to do. He is under an obligation to meet the cheques of his customer drawn upon his account, and is liable to him, if through fraud, error or misrepresentation, he pays his money against his instructions. This is based upon an implied contract between the banker and his customer that the former will honour all the cheques of his customer so long as there is sufficient balance to enable him to do so. But a banker is not bound to pay a part of a cheque.

A banker dishonouring a cheque is liable only to his customer and not to other parties. When paying his customer's money, the banker should, therefore, act diligently, for if a cheque, upon which the drawer's signature has been forged is paid, the banker is responsible to him. Similarly, the banker should not debit his customer in res-

pect of a cheque which he pays before its due date. A crossed cheque must always be paid through a bank, and a banker who neglects to do this does so at his own risk. The banker is not expected to know the signature of the payee or endorser, and so long as the endorsements purport to be those of the payee or endorsers, or made under their authority, the banker is not responsible for any wrong payment, provided he pays the cheque in the ordinary course of his business. Of course it is the duty of the banker to see that the endorsement is correct, for if it is not so he would not be protected. Similarly, if a banker receives a crossed cheque for collection from his customer, and he credits him before the cheque has been paid, he does it at his own risk.

The bank pass-book is the banker's record of transactions between him and his customer, and if the customer, relying upon the entries made in his pass-book, alters his position, the banker is responsible for the loss if it arises out of his own error in making the entries. On the other hand, if the banker pays a cheque for an amount greater than that standing at the credit of his customer, he cannot recover it from the payee, but the customer is liable to make good the deficiency.

The banker's authority to honour his customer's cheques is held up if an order of the court

countermands the payment, or the banker receives a notice of his customer's bankruptcy, lunacy or death.

Except under certain special circumstances, the banker is not authorised to disclose the account of his customer.

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## CHAPTER XV

### FOREIGN EXCHANGES

Foreign exchange is the science and art of international money changing. It means the buying and selling of the money of other countries and is treated in the same way as the purchase and sale of other commodities.

Foreign exchange refers either to the rate of exchange between one monetary centre and the other, or to the machinery by which international payments are made.

International trade is nothing but a sort of barter in which exports pay for imports, and it is very seldom that money is actually transferred from one country to another. Settlement of foreign debts by export and import of precious metals is uneconomical, troublesome and risky ; and this can be dispensed with by adopting another simpler and cheaper method.

The indebtedness arising from foreign trade is generally settled through the transfer of obligations, chiefly in the shape of paper instruments, called bills of exchange. This method of remittance is cheaper, easier and safer. While crossing the sea only once, a foreign bill pays more than one debt. Through the agency of specialised

institutions, known as exchange banks, which link the exporters and importers of goods, the bill transactions are effected.

The par of exchange is the fixed intrinsic value of the currency unit of one country expressed in terms of the currency of the other which uses the same metal as the standard of value. Exchange is said to be at par when that which was given is equal to that which was received. Par of exchange is of two kinds, *viz.*, the ideal par and the mint par.

Ideal par of exchange applies to those countries which have the same standard of value and use the same currency, at the same time having their foreign claims and obligations equal. Ideal par is, therefore, rarely attainable.

The mint par of exchange between two countries is arrived at by comparing the weights and fineness of their currency units. It is also applicable to those countries which possess the same standard of value.

The mint par is only a nominal rate of exchange. Due to constant fluctuations in the current rates, the mint par is never the existing rate, or if it is so, it is only a matter of chance. But from the mint par the specie points are deduced, and these set the limits beyond which the rates do not vary under normal conditions. The

market rate of exchange, though depending upon the mint par, is influenced by a variety of other important factors, and it oscillates up and down from the mint par. But there are limits beyond which the current rate cannot go. These limits are called specie (or gold) points. There are two specie points—the export and the import. The specie points are determined by the cost of transmitting gold from one country to another. When the market rate of exchange goes beyond the export specie point, so that it becomes more expensive for the exporter to purchase a bill of exchange and send it to his foreign creditor than to buy and export gold, specie begins to flow out of the country, and this tends to bring back the market rate to the normal point. Similarly, if the exchange rate falls below the import specie point, gold begins to be imported, which tends to restore the market rate to the central norm (*i.e.* the mint par of exchange).

High or low exchange does not imply any cheapness or dearness. It depends upon how the particular monetary centre quotes the exchanges. A peculiar feature of foreign exchange is that all the centres do not quote each other in the same way. Every country quotes a few monetary centres in its own currency and the rest in terms of foreign currency. In the case of those centres

which quote in their home currency, the higher rate is dearer and the lower rate is cheaper. Conversely, the higher rate is cheaper and the lower rate more expensive when exchanges are quoted in terms of foreign currency units.

The terms favourable and unfavourable exchanges are the relics of the Mercantilists who attached every significance to imports of precious metals which, they believed, could only be obtained by continuously having a favourable balance of trade. And they held that the rate of exchange which encouraged imports of gold was favourable, while the rate which led to exports of specie was considered as unfavourable. This theory errs on the side of principle, because an accumulated stock of precious metals in a country in excess of the requirements of industry and trade forces up the price level, encourages imports, turns the balance of trade against the country, and ultimately the stock of gold is reduced to such an extent that it is just sufficient for the needs of business. Due to this fallacy the terms favourable and unfavourable exchanges have now lost their significance.

The terms short and long exchanges refer to rates for short and long bills. The long rate is that at which a certain sum buys a bill to realise the same amount of cheque or telegraphic transfer which can be bought for that sum at the short



rate, allowance being made for the fact that the bill will be subject to a charge for discount and for bill stamp if a man to whom it is sent wishes to realise it at once. In long exchanges the determining factors are: First, the rate of discount in the market where the bill is drawn and also where it is payable; Secondly, the stamp duty chargeable on the long bills; and Thirdly, the insurance charges to cover certain amount of risk and uncertainty involved in such bills. Allowance for these factors being made, the long rates are governed by the short rates.

Spot or ready rates are the rates for the present delivery of exchange, while the forward rates refer to future delivery. The spot and forward rates of exchange between two monetary centres depend upon three principal factors, *viz.*, the distribution of funds of the dealers in exchange in the two centres, the rates of interest ruling in both the places, and the expected trend of the future market.

Upward and downward movements of the rate of exchange are called foreign exchange fluctuations. These fluctuations are of two kinds, *viz.* day-to-day or weekly fluctuations and seasonal fluctuations.

Day-to-day or weekly fluctuations are governed by the forces of demand and supply of foreign

bills on a particular day or week. When the quotations are in home currency, a rise in the demand for bills is reflected by a high rate of exchange and a diminution in their supply by a fall in the rate. Conversely, when the quotations are in foreign currency, the higher rate denotes an excess of supply of bills, and the lower rate an increase in their demand.

Seasonal fluctuations, on the other hand, spread over a period from a few months to several years. As already explained, fluctuations in the rate of exchange are the out-come of disparity between demand and supply of foreign bills. The different factors which give rise to the demand for and supply of these bills are: international trade; freight, commission and brokerage; loans to foreigners; clearing and accommodation bills; stock exchange and arbitrage dealings etc. As the demand for foreign bills exceeds their supply the exchange hardens; and when the supply of bills oversteps the demand for them the rate becomes loose.

By arbitrage operations we understand the transactions undertaken by exchange dealers with the object of realising profits from differences in the exchange rates. Such dealings are very complicated and hazardous, requiring considerable skill. They are conducted by bankers and other

financiers in conjunction with their agents and correspondents. The use of cable has greatly facilitated arbitrage operations.

Arbitrage is of various kinds. A simple form of arbitrage is that in which the broker purchases stocks or shares in one market and sells them in another at a profit.

Again, bankers sometimes make forward sales at stipulated rates, and at the same time they try to cover the sales by corresponding forward purchases in foreign centres at a cheaper rate, thus making a profit resulting from the difference in the price of the same class or kind of bills in different centres. In doing this they are only carrying on arbitrage operations; and such operations, in course of time, tend to equalise the price of such bills in the respective markets.

Another form of arbitrage consists in taking advantage of abnormal differences in the rates of different classes of bills in the same market.

Selling one class of bill with a view to purchase another is called stranding. The speculator who buys forward with the object of selling again at a profit before the date of settlement is known as bull-operator. On the other hand, the bear-operator is that who sells forward in the hope of buying again at a lower price before the date of settlement.

The theory of purchasing power parity is associated with the name of the great Swedish economist, Prof. Gustav Cassel of the Stockholm University. It was propounded by him during the Great War.

According to this theory, the normal rate of exchange between any two countries represents the relation between the purchasing power of their currencies.

Every rate of exchange does not represent the purchasing power parity. Only those rates which are the outcome of normal state of things represent such parity. In this theory the price level is the most significant factor; for it is the ratio of price levels which determines the parity. Price level, other things being equal, depends upon the demand and supply of money. Thus, the central point of the purchasing power parity theory is the quantity theory of money. In fact the theory of purchasing power parity is nothing but a formal expression of the quantity theory of money. Other things remaining unaltered, the quantity of money and the price level stand in a reciprocal relation to each other. The price levels of any two or more countries need not be equal. In fact they very rarely coincide due to the difference in national dividends, standards of living, mobility of labour and capital etc. The price level in one country,

other things being equal, cannot be higher than that in the other by more than the transport charges between them.

According to the purchasing power parity theory, the rate of exchange between any two countries cannot for a long time deviate from the purchasing power parity, which is determined by the relative purchasing powers of the currencies of the two countries. In other words, the theory asserts that it is not the balance of trade but the relative price levels which ultimately determine the normal rate of exchange. If disturbed, the parity is restored either by an alteration in the price levels or by an alteration in the rate of exchange. The peculiarity of the purchasing power parity is that it is a moving par, for it varies with a change in the price level in any one of the countries concerned. It does not, however, follow from this that with any change in the price level the rate of exchange will be disturbed, for, if in both the countries the prices increase or decrease to the same extent, the rate of exchange between them will remain unaffected.

Another conclusion from the purchasing power parity theory is that the normal rate of exchange of a country should be fixed at such a point where there is no disparity between the external and internal purchasing powers of the currency of that country. If there is a divergence, the existing

rate of exchange will not be normal and, therefore, it will not represent the parity. In such a case also the economic forces will tend to remove the disparity.

Though Dr. Cassel's theory is a laudable enunciation of an important economic tendency, it is not altogether free from objections. The difficulty of accurately measuring the changes in price levels; the limitations of the quantity theory of money which forms the basis of the theory of purchasing power parity; and the recent trends of economic history—all these factors have contributed towards reducing the practical value of the theory, and to-day very little beyond some academic importance has been left to it.

**CHECKED**  
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