Question No.1
What is paper Money, Describe its Merits and Demerits

Paper currency standard consists of paper money which is unlimited legal tender and token coins of cheap metals. Paper money may be either convertible of inconvertible. Convertible paper money is convertible into gold or silver coins or bullion of specified weight on demand. Paper money is not convertible into coins of a precious metal of bullion nowadays.

Therefore it is inconvertible. People accept it because it is legal tender. Since it has the command of the government, people have to accept it. That is why it is also known as 'fiat money' or standard. It is also referred to as managed standard because the issue of paper money and token coins is managed by the central bank of the country.

MERITS OF THE PAPER CURRENCY STANDARD

The paper currency standard which is universally used, has a number of merits. Some of these are stated below.

1. Economical: The paper currency standard is cheaper than the gold or silver for coinage purpose. Rather precious metals can be used for productive purposed and for making payments for foreign countries. As paper money is not convertible, there is no need to keep gold in the form of reserves. The money authorities keep only a fixed quantity of gold in reserve for reasons of security. Thus paper standard is cheap and economical and even a poor country can easily adopt it.

2. Elastic: The paper standard is a highly useful. Monetary system because it possesses great elasticity. The monetary authority can easily adjust the money supply in accordance with the requirements of the economy. This was not possible under the gold standard. The supply of money can be increased by printing more notes in times of financial emergency, war and for economic development. It can also be reduced when the economic situation so demands. Thus there is also freedom in the management of the money supply in the economy.

3. Price Stability: The paper standard ensures price stability in the country. The monetary authority can stabilise the price level by maintaining equilibrium between demand and supply of money by an appropriate monetary policy.

4. Free from Cyclical Effects: The paper standard is free from the effects of business cycle arising in other countries. This merit was not available to other monetary standards, especially the gold standard, where cyclical movements in one country were automatically passed on to other countries through gold movements.

5. Full Utilization of Resources: The gold standard had a deflationary bias where by the resources of the country remained unutilised. Whenever there was gold out of flow, the prices fell and resources became unemployed. But this is not the case under the paper standard in which the necessary authority can manipulate the monetary policy in order to ensure full utilization the country's resources,

6. Equilibrium in Exchange Rate: One of the merits of the paper standard is that it immediately restores equilibrium in the exchange rate of a country whenever disequilibrium occurs in the demand and supply of its currency in the foreign exchange market.

7. Portable: It is very convenient to carry large sums of paper money from one place to another.

8. Easy to count: It is easier count paper money than metallic money.

9. Easy to store: It is easier to store large sums of paper money in a small space.

10. Cognizable: It is easy to recognise paper notes of different denomination.

11. Replaceable: Paper notes of one type and denomination can be easily replaced by printing notes on different types of the same denomination.

DISADVANTAGES OF THE PAPER CURRENCY STANDARD

Despite above mentioned merits, the paper currency standard has certain disadvantages, these disadvantages are mentioned below.

1. Inflationary Bias: One of the serious defects of the paper standard is that it has an inflationary bias. As paper notes are inconvertible, there is every likely hood of the government printing note in excess of requirements. Or the government may deliberately

resort to the printing press to meet a financial emergency or war or even to need ordinary budget deficits. This leads to excess of money supply and to inflation in the country.

2. Price Stability a Myth: In the merits of the paper currency standard it has been pointed out that it leads to price stability. Actually price stability is a myth as has been experience of the majority of the countries on the paper standard.

3. Exchange Instability: Another disadvantage of this system is that it leads to instability in exchange rates whenever there are large fluctuations in external prices an against internal prices. Such wide and violent fluctuations in exchange rates are harmful for the growth of international trade and capital movements among countries. These have led governments to adopt exchange control measures.

4. Lacks Confidence: Paper money lacks confidence as it is not backed by gold reserves.

5. Lacks Durability: Paper money has less durability than metallic coins. It can be easily destroyed by fire or insects.

6. Unstable: Paper money lacks stability because its supply can be changed easily.

7. Uncertainty: Instability in the value of paper money leads to uncertainty in the economy which adversely affects business and economic progress of the country,

8. Token Money: Paper money is token money and in the event of demonetization of notes they have no intrinsic value and are simply like wrote papers.

9. Not Automatic: The paper currency standard does not operate automatically. It is highly managed standard which requires much care and caution on the parts of the monetary authority. A little carelessness may bring disaster to the economy.

Question No.2
Define Trade Cycle, Explain its Causes and remedies

DEFINITION OF TRADE CYCLE:

"A trade cycle is composed of periods of good trade characterized by rising prices and low unemployment percentages, alternating with periods of bad trade characterized by falling prices and high unemployment percentages".

(Keynes)

CAUSES OF TRADE CYCLE

The main causes of trade cycle are classified into following two groups:

(a) INTERNAL CAUSES

(1) Less Consumption:

During the boom period, the prices of goods or commodities rise due to increase in profits of businessmen which results in the reduction of consumption level.

(2) Unsold Inventory:

Trade cycle occurs due to unsold inventories. The income of working class is low so they cannot purchase the goods. As a result the goods remain unsold and the period of depression starts.

(3). **Labour Unions:**

The labour unions demand for increase in wages. Due, to this the cost of product goes up and the profit margin reduces. As a result the demand and production of goods fall.

(4) Liquid Assets:

The liquid assets include currency notes, bonds, securities, gold and shams etc, increase in liquid assets increases the rate of investment. Due to this, the stock exchange activities flourish and economy leads towards boom.

(5) Research & Development:

The research and development are the basic tools for advancement and prosperity. If the domestic producers do not pay proper attention towards improvement of their

products , then imported products attract local consumers which harmfully affects the local industry.

(6) Supply of Credit & Money:

The changes in credit and money supply have a major affect upon the level of economic activities. An increase in the supply of money and credit expands the economic activities and vice versa.

(b) EXTERNAL CAUSES

(7) Mismanagement:

Monetary and fiscal mismanagement i.e., supply of money, credit volume, government expenditures and taxes leads towards depression. A wrong decision in this regard may result in a series of problems. Thus, if the policies are managed in proper way
then the country will move towards prosperity.

(8) Trade Deficit:

When export earnings are lower than imports, the country is said to run trade deficit.
It means more money is going out than what is coining in. A continuous trade deficit leads
towards depression.

(9) Budget Deficit:

Budget balances the government expenses and revenues. If revenues exceed expenses then there is budget surplus. If expenses exceed revenues then there is budget deficit. Budget deficit is removed by borrowing loan. This will increase burden of debt of the state and it will impose taxes that reduce the quantity of investors / producers. This situation moves towards depression.

(10) Climate or Weather

The good and bad weather affect the production. in agriculture sector. In case of bad weather, the production remains low which leads towards depression. But if weather conditions are good, production will be high and economy moves towards prosperity.

(11) Wars:

Wars bring damages to the economy because it results in the decrease of investment, income, employment and price level. So, the economy tends to be in the phase of depression.

(12) Population Growth:

If the rate of population growth is higher than the rate of economic growth then the prices of goods will increase. As a result the purchasing power of the people reduces and the economy moves towards decline.

(13) Inventions:

Inventions lead to high level of competition in the economy and it brings big investment in the economy, This phase shows that economy is entering in the Phase of boom.

Remedies of Trade Cycle:

(1) Fiscal Policy:

Tax is a tool of fiscal policy to control the trade cycle. The government can impose more taxes during the boom period to control economic activities. During depression the government can reduce taxes and increase investment / expenditures to help the economy.

(2) Monetary Policy:

Monetary policy is concerned with the balanced supply and credit and money. If there is a depression in the economy then the supply of credit and money increases so that rapid investment takes place and economy expands. During boom, there is always a danger of inflation and the central bank can also use monetary Policy to contract the supply of credit and money.

(3) Budget:

Budget is a part of fiscal policy to control trade cycle. The surplus budget can be prepared during boom period to utilize in the phase of depression to meet budget deficit.

(4) Population Rate:

Population growth rate has a great importance in the modern economy. A low population growth rate helps the government to control economy better and make it more resistant against the bad effects of trade cycle.

(5) Political Conditions:
Political instability leads to economic instability. By having political stability am long-term government, economy can be saved from trade cycle.

(6) Investment & Saving:
Higher savings can lead to contraction in the economic activities and higher investments can lead to unnecessary / harmful expansion in the economic activities. Saving and investment should be balanced in such a way that growth rate of economy is sufficiently ahead of population growth rate.

(7) Research & Development:
The most effective tool in controlling trade cycle is research and development. Research and development lead to new and improved products (innovation), which can maintain higher level of production without increasing the cost. Thus, research an development lead to improvement in the living standard of masses.

Question No.3
Explain the main Functions of Central Bank

The functions of State Bank of Pakistan are governed by the State Bank of Pakistan Act 1956 State Bank of Pakistan will continue performing its four basic functions.

(i) Framing and operation of monetary policy
(ii) Regulations and supervision of banks and financial institutions
(iii) Foreign exchange management
(iv) Settlements of payment and accounts.

The basic functions performed by State Bank of Pakistan are now discussed in brief as under.

1. **STATE BANK AS A BANK OF ISSUE**
The State Bank of Pakistan has the role right to issue notes except subsidiary coins which are issued by the Government. The Bank adopted the Proportional Reserve System for the issue of notes upto December 1965. The level of currency banking by gold bullion, foreign securities is now fixed 1200 million through an ordinance in December 1965.

This system of note issue is known as minimum Reserve System. The size of notes issue reflects the public demand for money. The amount of notes in circulation can be increased to meet the public demand and are adjusted according to the general level of prices and economic activity in the country. The assets of the Issue Department are always equal to liabilities.

2. FRAMING AND OPERATION OF MONETARY POLICY
The State Bank of Pakistan frames and operators the monetary policy. Monetary policy is conducted by the State Bank of Pakistan to regulate and control the volume of money and credit supply in the country in order to achieve specific economic objectives such as price stability, reducing unemployment, etc.

The main instruments of monetary policy are
(i) Open market operations
(ii) Changing the reserve requirement and
(iii) Changing the discount rate.

(i) Open market Operations: Open market operations technique is used for expanding or contracting the money supply in the country. By buying the Govt. securities in the open market, the State Bank of Pakistan expands the money supply and by selling securities it contracts the money supply in the country.

(ii) Changing the reserve requirements: The state bank of Pakistan also controls the money supply in the country by changing cash reserve requirements of the commercial banks. An increase in the cash reserve ratio reduces the excess reserves of the bank and curtails the powers of the banks to advance loans.

The decrease in the cash reserve ratio increases the cash reserves of the commercial banks which increase the capacity of the banks to advance more loans. The State Bank of Pakistan now requires the scheduled banks to maintain at least 35% of demand and time liabilities with it.

(iii) Changing Discount rate: The bank rate is the rate of interest at which the State Bank of Pakistan discounts the first class bills of exchange.

The rise in the bank rate pushes up the cost of borrowing of commercial banks and reduces money supply in the country. A decrease in the bank rate works in the opposite direction.

3. REGULATION AND SUPERVISION OF BANKS

The State Bank of Pakistan has full powers to supervise and control the banking system in the country. The regulatory powers relate to the licensing of banks, and their branch, expansion, liquidity of assets of banks, management and methods of working of the banks amalgamation and reconstruction and liquidation of banks, inspection of banks etc.

4. FOREIGN EXCHANGE MANAGEMENT

The State Bank of Pakistan acts as custodian of foreign exchange reserves manages exchange control and external value of the rupee and acts as the agent of the government in respect of Pakistan's membership of IMF. An important aspect of foreign exchange management is that all foreign exchange transactions are made at the official rate of exchange. It also maintains the exchange value of the rupee in terms of other major currencies of the world.

5. STATE BANK AS A CLEARING HOUSE
The State Bank of Pakistan acts as Clearing House for the commercial banks. A clearing house is a place where representatives of commercial banks meet each day to exchange cheques drawn on each other and then settle the differences owed to each other. State Bank thus helps the commercial banks in making millions of payments by a minimum of transactions.

6. ADVISOR TO GOVERNMENT
The State Bank of Pakistan also acts as advisor to government in all financial matters. Since State Bank of Pakistan is directly involved in the money and foreign exchange markets, it, therefore, tenders advice on all economic matters. It also provides advice to commercial banks and other financial institutions and to commerce and industry in general.

7. LENDER OF LAST RESORT
The State Bank of Pakistan is the lender of last resort for the commercial banks. It at any time the banks are short of cash reserves, the State Bank of Pakistan comes to their rescue. It provides cash to commercial banks by re discounting bills of exchange and treasury bills. The State Bank of Pakistan thus helps and maintain liquidity ad solvency of the commercial banks.

8. STATE BANK AND ECONOMIC GROWTH
The State Bank of Pakistan is playing a significant role in facilitating and fostering economic development and growth of banking system and other financial institutions in the country.

The main development promotional activities of the Bank are as follows.

(a) The development of the capital market in the country owes a great deal to the efforts made by the State Bank of Pakistan.

(b) Under the State Bank's Export Finance Scheme, the commercial banks provide finance to the exporters at the concessional rate.

(c) The State Bank of Pakistan has helped in the establishment of specialized credit institutions for meeting the medium and long term credit needs of the various sectors of the economy. These institutions include IDBP, NIT, EPF (Equity Participation Fund), HBFC, ICP (Investment Corporation of Pakistan) Banker's Equity Limited, Pakistan Industrial Credit and Investment Corporation, Small Business, Finance

Corporation etc.

The following functions which the State Bank of Pakistan hade been performing and which involved public dealings have been transferred to the State Bank of Pakistan Banking Services corporation. The new corporation has started functioning from January 2, 2002 as a subsidiary organization of State Bank of Pakistan.

Question No.4
How do commercial banks employ Funds?

Commercial banks use their funds to make the maximum profit. The important use of these funds is advancing loans (Financing). Banks also keep some of their funds as cash reserve to meet their current obligations. Main uses of bank funds are:

(1) ADVANCING LOANS:

The loans are granted to the different sectors of economy to meet the increasing needs of economic development. The commercial banks after evaluating the prospective borower's application precisely and objectively extend credit for a certain period.

Loans are mainly divided into two parts.

(a) Secured Loans:

The loans granted after keeping certain valuables as security (collaterals) are known as secured loans.

(b)Unsecured Loans:

The loans against which no security is kept with the bank are called unsecured loans. These loans are granted when goodwill or personal guarantee of borrower is thought enough.

Following are the kinds of secured and unsecured loans issued by banks

i) Demand Loans:

These are the loans, which can be demanded by the bank at any time. Generally these loans are issued to rich and trust worthy people. The loans have no fix-determined period and can be determined at any time in need. Demand loans play important role to meet the immediate requirement of businessmen. Generally the bank issue such loans to stock exchange brokers on the security of first class shares and debentures.

(ii)

Overdraft:

Banks allow their trustful customer to draw more than the deposited amount in bank. BANK charge interest on O.D. In modern banking oerdraft facility is known as "Running Finance". The facility of O.D. is only provided to current account holders.

(iii) Discounting of B/E:
This is also a source of income for the bank to discount bills of exchange. They charge nominal interest and discount only on the reputed and clear bills of exchange.

(iv) -
Cash Credit:
Banks also give cash credit against current assets such as shares and bonds etc. In this type of loan interest is charged on the amount actually withdrawn.

(v) Fixed Loans (By Opening Loan Account):
If the amount and period for a loan are decides before its issue then it is called fixed loan. The amount of loan is transferred to loan account in the name of borrower while interest is charged on the whole amount whether utilized or not. The banks ask movable and immovable securities for such loan. These loans may be of following types.

(a) Short Term Loans:
These loans are granted to meet the day-to-day requirements of the business for the period up to one year.

(b) Medium Term Loans:
These loans are given to purchase raw material and to meet the administrative expenses for the period of one to five years.

(c) Long Term Loans:
These loans are issued for the purpose of investment and to purchase fixed assets for the period of 6 to 10 years.
Note: The concept of medium term loan has been vanishing gradually in modern banking.

(2) DIRECT INVESTMENT:
Some banks having sound financial background establish their own business Projects like manufacturing units, commercial enterprises etc. By this type of investment banks can earn more profit through direct o rations.

(3) PURCHASE OF SHARES AND DEBENTURES:
Banks also employ their funds in purchasing shares and debentures of different companies to earn profit. Some times they purchase more than 50 % shares of a company and become the authority in all the decisions of the company due to majority.

Question No.5
Define monetary policy and 'discuss its various tools (Methods of credit control).

Monetary policy is the process by which the monetary authority of a country controls the supply of money, often targeting a rate of interest for the purpose of promoting economic growth and stability. The official goals usually include relatively stable prices and low unemployment

The important quantitative or the general methods of credit control are as follows.

(i) Bank Rate or Discount Rate Policy
(ii) Open Market Operations
(iii) Variable Cash Reserve Ratios

These methods are discussed in brief as under.
(i) Bank Rate or Discount Rate Policy:
The bank rate policy is one of the principal methods of general credit control. It is the earliest method of credit control which was used by the Bank of England till the out break of the First World War. But later on with the change in economic conditions in Great Britain, the bank rate policy became rather ineffective and the Bank of England was compelled to advise other methods of credit control which were more effective than bank rate policy.

The Central Bank, thus tries to control credit (through Bank Rate Policy) by influencing both the cost as well as the availability of credit. The cost of credit is influenced by changing the bank rate. By raising the bank rate or the discount rate, the Central Bank raises the cost of credit and by lowering the bank rate or the discount rate, it lowers down the cost of credit. The bank rate policy also affects the availability of credit by changing the conditions under which the Central Bank grants loans to the commercial banks. Thus the bank rate policy influences both cost as well as the availability of credit.

(ii) Open Market Operations:
Open market operations as a method of credit control developed only after the First World War. The term 'Open Market Operations' is used in two senses. In the narrow sense open market operations imply the purchase and sale by the Central Bank of government, securities in the money market. Bank in the broad sense this term implies the purchase and sale by the Central bank not only of government securities but also of

other eligible papers like bills and securities of private concerns.

(iii) Variable Cash Reserve Ratio:
This method of credit control requires variations in the cash reserve ratio of commercial banks. It was first suggested by Lord Keynes who did much to popularize it as a method of credit control by the Central Bank. The theory underlying the method of Variable Cash Reserve Ratio is that by changing the cash reserve ratio, the cash reserves of the commercial banks can be directly changed, affecting thereby their ability to create credit in the economy. This can be illustrated by an example. Let us suppose that the commercial banks have excessive cash reserves on the basis of which they are creating too much credit.

The Central Bank considers this over expansion of credit as harmful for the larger interests of the economy. So it will raise the cash reserve ratio which the commercial banks are required to maintain with the Central Bank. This will automatically sterilize a part of the cash reserves of the commercial banks and force them to curtail the creation of credit in the economy. In this way by raising the cash reserve ratio of the Commercial Banks, the Central Bank will be able to put an effective break on the inflationary expansion of credit in the economy.

Selective Credit Control

Qualitative or Selective credit control is a recent development in monetary management by the Central Bank. The objective of qualitative control is to divert the flow of credit into particular uses or channels in the economy. In fact the objective of selective credit control is to encourage the flow of credit into those uses or channels which help the growth of economy.

The following are the main types of selective credit controls exercised by the Central Bank.

1. Fixation of Margin Requirements on secured loans.
2. Regulation of Consumer Credit.
3. Control through Directives by Central Bank.
4. Rationing of Credit.
5. Moral Suasion.
6. Publicity.
7. Direct Action.

All the above mentioned types of selective credit control are discussed as under.

1. Fixation of Margin Requirements:
The margin is the difference between the 'loan value' and the 'market value' of securities offered by borrowers against secured loans. By prescribing the margin requirements on secured loans, the Central Bank does not permit the commercial banks to lend their customers the full value of the securities offered by them, but only a part of their market value.

To start with, this method was applied to stocks and shares only. But now its scope has been extended to cover goods stored in authorized godowns. At present, this method is being extensively used by developing as well as developed countries to check the flow of credit into undesirable speculative activities.

2. Regulation of Consumer Credit:
As we are aware that, durable consumer goods such as T.Vs, refrigerators, washing machines, motor vehicles etc are purchased in Western countries by the consumer on installment credit. According to this system, a certain percentage of the price is paid by the consumers in downright cash.

The remaining part of the price is financed by bank credit which is repayable by the consumer in installments spread over a specified period of time. The objective of this method is to curb the consumption of durable consumer goods which happen to be in short supply in the economy.

This method controls excessive consumer demand for durable goods. This method was first introduced by the Federal Reserve System in the U.S.A. in August 1941 to regulate the terms and conditions under which credit repayable in installments could be extended to the consumers for purchasing durable goods. Later on the method of consumer credit regulation was adopted by Central Banks in other countries, such as those of Britain, Canada, Australia and New Zealand.

3. Control through Directions:
Sometimes, selective credit controls may be enforced on the commercial banks through directives issued by the Central Bank from time to time. These directives may be in the form of written orders, appeals or warnings by the Central bank addressed to the commercial banks. These directives are issued to the commercial banks in order to realize the following objectives.

i) To divert credit less urgent uses to more urgent uses.
Or from less productive uses to more productive use.
ii) To prohibit lending for certain purposes altogether.
iii) To fix maximum limits of credit for certain purposes.

The commercial banks generally decide by the directives issued to them by the Central Bank from time to time. These directives generally supplement the traditional weapons of control, such as, the bank rate and open market policy.

4. Rationing of Credit: This is another weapon in the armoury of the Central Bank. Rationing of credit as an instrument of credit control was first used by the Bank of England in the closing years of the eighteenth century. The term 'rationing of credit' implies two things, first it means that the Central Bank fixes a limit upon its rediscounting facilities for any particular banks. Second it means that the Central Bank fixes the quota of every affiliated bank for financial accommodation from Central Bank.

This method of rationing of credit has a historical background. Due to the operation of the usuary law, the Bank of England could not raise its rate of discount beyond maximum limit of 5 percent. It was not possible for the bank to discourage excessive borrowing from it by the banks during periods of monetary stringency. The Bank of England was thus compelled to ration credit among the member banks. But after the repeal of usuary law, the method of rationing of credit lost its importance in Britain. Central Banks in other countries such as Germany, France, and Mexico also make use of this method to check excessive borrowing by the commercial banks from Central Bank. The rationing of credit as a method of credit control occupied a prominent place in Soviet Economic planning.

5. Moral Suasion:
The moral suasion method is frequently employed by the Central Bank to exercise control on the commercial banks. This method involves advice, request and persuasion with commercial banks to cooperate with the Central Bank in implementing its credit policies. If the commercial banks do not abide by the advice or request of the Central Bank, no punitive action is taken against them.

The Central Bank merely uses its moral influence with the commercial banks to prevail upon them to accept its policies. For example, the Central Bank may request the commercial banks not to extend credit for speculative purposes or it may request the member banks not to press with the demand for additional financial accommodation

from it. The Central Bank under this method can only appeal to the patriotic and nationalistic sentiments of the commercial banks. The Central Bank may even hold occasional conferences with the commercial banks to make its policies known to them. Anyway, the method of moral suasion is a purely informal method with no legal sanction.

The method of moral suasion has also its limitations. The main drawback of this method is that it lacks legal sanction. As such, it fails to be effective at a line when the forces of credit expansion in the economy happen to be very strong and powerful. Nevertheless, this method has its uses and can serve as useful supplement to other methods of credit control.

6. Publicity: Central Banks have adopted publicity as an instrument of credit control. They use this instrument not only for influencing the credit policies of commercial banks but also to educate and influence public opinion in the country. In fact publicity is an essential instrument to ensure the effectiveness of the monetary policy of The Central Bank. Under this method the Central Bank gives wide publicity to what is good and what is bad in credit system of the country. The Central Bank gives wide publicity to its thinking in the field of bank credit. The commercial banks, in their turn are guided by the ideas of the Central Bank in matters relating credit creation.

Publicity as a method of credit control has been very extensively used in the U.S.A. when the Federal Reserve System regularly publishes reports regarding the credit creating activities of the member banks. The method is also widely used by the Central Bank in Germany and Sweden. The State Bank of Pakistan also periodically published returns and statements about the affairs of commercial banks. There is some controversy going on amongst the economists with regard to effectiveness of publicity as a method of credit control. While some economists feel that publicity is useful instrument of credit control, there are others who are of the opinion that it is at best only a minor instrument of credit policy.

7. Direct Action: The method of direct action is most extensively used by the Central Bank to implement their credit policies. This methods can be used to enforce both quantitative as well as qualitative credit controls by the Central Banks. This method is not used in isolation, it is used as a supplement to other methods of credit control.

This method of direct action implies the use of coercive measures against those commercial banks whose credit policies do not confirm to the declared objectives of the Central Bank. This method also involves the issuing of general instructions by the

Central Bank to all the commercial banks. It may also take the form of special instructions by the Central Bank issued to erring banks. It should however by remembered that the method of direct action is sued only as last resort when other methods fail to yield the desired result.

The method of direct action can prove effective only when the Central Bank is armed with sufficient Legal powers to enforce its directives on the commercial banks. Hence the Central Banks in several countries have been given statutory powers to take drastic action against the defaulting banks.

According to recent Central Banking legislation, the Central Banks in different countries have been given extensive powers under the law to formulate the general credit policy to be followed by the commercial banks. They have also been authorized to prescribe rates of interest to be charged on different types of loans and advances.

Question No.6
What is Letter of Credit, Explain Different Kinds of Letters of Credit.

LC and its Kinds

A letter of credit is a document issued by a financial institution or a similarly accredited professional party. The letter assures payment to a seller of goods or services provided certain documents have been presented to the bank.

Types of Letters of Credit

Traveler's letters of credit, which were commonly used in eighteenth century, were the first financial instrument contains very similar characteristics with the contemporary letters of credit.

Commercial Letters of Credit
Commercial letters of credit are mainly used as a primary payment tool in international trade such as exporting and importing transactions. Majority of commercial letters of credit are issued subject to the latest version of UCP (Uniform Customs and Practice for Documentary Credits). The ICC publishes UCP, which are the set of rules that governs the commercial letters of credit procedures.

Standby Letters of Credit
Commercial letters of credit are a means of payment to be utilized when the principal perform its duties. As an example, let us consider an exporter who ships the goods according to the sales contract and apply to the nominated bank for the payment. If the nominated bank decides that the presentation is conforming to the terms and conditions of the credit and the UCP rules then exporter will be paid. This situation is just contrary in standby letters of credit.

A payment is made to the beneficiary of a standby letter of credit when there is a breach of the principal's obligation. As an example, let us consider a construction company that has been awarded with a tender. If this construction company cannot fulfill its obligations under the project contract beneficiary of the standby letter of credit can apply to the nominated bank for the payment.

However, the nominated bank considers only the terms and the conditions of the standby letter of credit and the rules governing the credit when deciding a complying presentation. One point that needs to be stressed is that standby letters of credit have

their own rules, which are called The International Standby Practices 1998 (ISP98). They are also published by ICC. However, a standby letter of credit can be issued subject to either the UCP or the ISP.

Revocable Letters of Credit
Revocable letters of credit give issuer the amendment or cancellation right of the credit any time without prior notice to the beneficiary. Since revocable letters of credit do not provide any protection to the beneficiary, they are not used frequently. In addition, UCP 600 has no reference to revocable letters of credit. All credits issued subject to UCP 600 are irrevocable unless otherwise agreed between the parties.

Irrevocable Letters of Credit
Irrevocable Letters of Credit cannot be amended or cancelled without the agreement of the credit parties. Unconfirmed irrevocable letters of credit cannot be modified without the written consent of both the issuing bank and the beneficiary. Confirmed irrevocable letters of credit need also confirming bank's written consent in order any modification or cancellation to be effective.

Question No.7
What are the Causes, Merits and Demerits of Nationalization of Banks in Pakistan ?

Causes, Merits and Demerits of Nationalization of Banks

In the period of Mr. Zulfiqar Ali Bhutto government nationalized basic industries in 1972. Life insurance company was also nationalized in the late 1972. Vegetable ghee units were nationalized in 1973. Commercial banks and shipping were take it over in 1974. While flour mills, rice bushing and cotton ginning factories were nationalized in 1976.

MAIN CAUSES or ADVANTAGES OF NATIONALIZATION :

Following were the main causes of nationalization :

1. Equal Distribution of Wealth :-
The government nationalized the industries and banks to provide equal distribution of wealth. Because few families had full control over the major portion of national wealth. So government decided to provide equal chances of earning to the people by nationalizing the units.

2. End of Monopoly :-
There was complete hold of few capitalists over the supply of the market. They were charging higher prices from the consumers. To remove the monopolies government nationalized the industries, so that goods should be provided to the public at lower price.

3. Check on Smuggling and Hoarding :-
The government nationalized the various banks on this ground that capitalists were misusing the savings of the whole nation. They used the credit for hoarding and smuggling.

4. Fair Distribution of Credit :-
The banks were nationalized to provide the fair distribution of credit. All the classes of the public will enjoy the credit facilities. Small farmer and small businessman was ignored by the banks before nationalization.

5. Economic Stability :-
It was also argued that all the business institutions will adopt uniform policy after nationalization. It will provide economic stability.

6. Effective Planning :-
It was also argued that after nationalization government will prepare the plans more effectively and the rate of out put will rise.

7. Increase in Production :-
It was also argued that after nationalization the labour will work more honestly and efficiently to increase the production of these units.

8. Increase in Social Welfare :-
Before nationalization all the profit of industries and banks was in few hands. But after nationalization it will be used for the best interest of the whole nation.

9. Price Stability :-
It was also climes that state bank can minimize the fluctuation in the economic activity with the help of nationalized commercial bank.

DISADVANTAGES OF NATIONALIZATION

1. Increase in Corruption :-
The nationalized industrial units were handed over to the government officials and it increased the corruption in this sector. Efficiency of the units reduced after nationalization.

2. Fall in Production :-
After the nationalization production of various units decreased and rate of profit removed. The managers of those units did not pay proper attention.

3. Sick Industries :-
In the short period these industries suffered a loss and were declared sick industries.

4. Carelessness of Labour :-
After nationalization workers became careless about their duties and this attitude of labour affected the production adversely.

5. Public Sector Over Weighted :-
Public sector has become overweight and it is health risk for the economy. More over public sector is flourishing at the expenses of private sector.

6. Private Sector Discouraged :-
The nationalization policy discouraged the private sector, and due to this rate of investment decreased. Even the target of private investment in the 8th five year plan could not achieved due to the fear of nationalization.

Keeping in view above defects government of Pakistan denationalized the various industries. Now in the present budget of government has provided various incentive to promote the private industrial sector. Present government is trying is best to encourage the private industrial sector.

Question No.8
What is business finance? Discuss sources of Business finance.

DEFINITIONS OF BUSINESS FINANCE:

"Finance consists of providing and utilizing the money, capital, rights, credit and funds of any kind which are employed in the operation of an enterprise.

"Business finance is concerned with acquisition and utilization of capital funds in meeting the financial needs and overall objectives of business enterprise.

TYPES OF SOURCES OF BUSINESS FINANCE.

There are following three types of business finance:

(1) SHORT-TERM FINANCE:

The borrowing or lending of funds for the period of one year or less is known as short-term finance.

Main features of short-term finance are:

(a) Available at low rate of interest.

(b) Seasonal requirements of business can be met easily.

(c) No need to keep heavy cash balance.

(d) It is considered blessing for unforeseen expenditures.

SOURCES OF EQUITY FINANCE

(i) Loan by Owner:

Sometimes the owner or partner of the business concern provides short-term loan to business in the hour of need from his personal sources in addition to contributed capital.

(ii) Advance Payment by Owner:

If the owner wants to buy the goods, produced by his own business, for domestic or personal use then he can provide short-term finance to business by making total or partial payment in advance.

SOURCES OF DEBT FINANCE

Commercial Banks:

These banks receive the savings of public as deposits and lend them to the businessmen for short period. These loans are granted in shape of overdraft and cash credit
(Running Finance).

Friends & Relatives:

A number of persons obtain loan from friends or relatives in the time of need, but it is LIMITED AND INDEFINITE

Indigenous Bankers:
This type of source includes, small money lenders i.e Sahukar, Mahajan, Zamindar grant loans on high rate of interest.

(iv) Public Deposits:
Some commercial units receive deposits from the public for short period on

favourable terms, Thus they are in the position to utilize these funds for their business requirements.

(v) Co-operative Societies:

These societies render valuable services in providing loans to rural businessmen against the security of land.

(vi) Trade Creditors:

Trade creditors include wholesalers, retailers and manufacturers who supply goods on credit basis to the traders.

(vii) Customers:

Sometimes customers provide short-term funds by making advance payment of goods before their delivery.

(viii) Factors:

They grant credit on the security of account receivables. Thus they take over the risk of bad debt losses.

(2) MEDIUM-TERM FINANCE:

If the borrowing or lending is made for one to 10 years, it is called medium term or intermediate financing. Some other banking experts say that the period of intermediate finance is one to 5 years. Main features of medium-term finance are as under:

(a) It is required to purchase new machinery or equipment.

(b) If the entrepreneur wants to introduce new product.

(c) For renovation work including repair, improvement, alteration and addition to plant.

SOURCES OF EQUITY FINANCE.

(i) Loan by Owner:

The sole owner in sole trader ship and partners in partnership business provide medium term loans from their personal sources in case of capital deficiency. Moreover, the business concern does not require to fulfill any legal formality in this regard.

(ii) Other Sources:

In some business units, the directors, managing agents and officers may provide loans to business for medium term.

SOURCES OF DEBT FINANCE

(i) Life Insurance Companies:

Insurance companies have steady or regular income in form of premium, so they grant medium-term finance to industrial units and businessmen.

(ii) Partial Payment Method:

Some manufacturers sell their goods on both cash and intallment basis. Some portion of the price is paid at the time of goods purchased and the balance is partially paid or on installment basis . This Method of buying goods is also a source of getting medium term finance.

(iii) Agents:

Sometimes managing agent also provides or arranges medium term finance for the concerned business due to their vast contacts in business community.

(iv) Financial Institutions:

The financial institutes of a country grant medium term finance to the businessmen (e.g.) PICIC, IDBP and ZTBL etc. in Pakistan.

(v) TFC's:

The company in the favor of lending institutions issues term Finance Certificates. The mark up on the money borrowed paid in installments.

(vi) PTC's:

A company for meeting its medium term finance requirements issues participation term certificates. The instrument is issued to replace debenture financing.

(3) LONG-TERM FINANCE:

Long-term finance is generally obtained for more than ten years some other experts argue that the period of long term finance is more than five years. Following are the main features of long-term finance.

(a) It is used for the purchase of permanent or fixed assets such as land, building,plant and machinery etc.

(b) It is generally needed to start a big business.

(c) High rate of interest is charged.

SOURCES OF EQUITY FINANCE

(i) Reserve Fund: A company does not distribute its total profit among the shareholders. It transfers a part of profit earned to reserve fund every year to meet the unexpected expenditures in future.

ii) New Partners: Inviting new partners in a firm and issuing new share in a company can increase the volume of capital.

iii) Underwriters:
Their services cannot be ignored in obtaining long-term loans for public limited companies. They take the responsibility to dispose of the securities of companies and receive commission.

(iv) Musharika Investment:
Musharika certificates also meet the capital requirements of a business and profit is distributed according to agreed ratio.

(v) Modaraba Certificates:
Long-term loans are obtained by issuing modaraba certificates, which may be used for specific or multiple purposes.

SOURCES OF DEBT FINANCE

(1) Bonds:
Under this scheme, large size businesses units issue secured and unsecured bonds, which may be disposed of directly or through agents.

(ii) Debentures:

The debentures are also issued to avail long-term finance against the assets of company. The interest and time period for their redemption is also fixed.

(iii) Mortgage:

These loans are obtained from financial institutions against the security of immovable property like land and building etc.

(iv) Financial Institutions:

The specialized financial institutions of the country provide long-term finance to different industries and sectors. For example, PICIC, ZTBL and IDBP in Pakistan.

(v) Leasing:

In leasing the lesser transfers the rights of using an asset to lessee for a specific period of time. The ownership of asset remains with the lesser. The lessee pays the lease rentals according to agreed terms.

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