INFLATION

DEFINITIONS:

(i) ***"Inflation is a rise in price level after the full employment has been achieved".***

(J.M. Keynes)

(ii) ***"Inflation is nothing more than a sharp upward movement in the price level".***

(Kent)

CAUSES OF INFLATION

(1) Deficit Financing:

In developing countries like Pakistan, the surplus currency issued by the Central Bank is spent for the constructional and development work in the country, which creates inflation.

(2) Increase in Population:

The growth of population is very high which is resulting in the shortage of commodities; therefore prices have increased in the country.

(3) Increase in Wages:

Increase in wages has increased the purchasing power of the people. Wages and price chase each other. When wages increase then price also increases.

(4) Decrease in Production:

Due to agricultural and industrial backwardness, there is less production of commodities in the country. Due to which the prices have increased in the country.

(5) Devaluation:

Devaluation refers to the fixation of low rate of exchange of the national currency in terms of foreign currency. Due to devaluation price level increases and imports also become costly.

(6) Oil Crises:

Due to increase in the prices of petroleum, the price of each and everything has increased. Prices of petroleum indirectly links with the prices of all the commodities.

(7) Export of Consumer Goods:

Due to the increase in export of consumer goods and raw goods to foreign markets, the quantity of goods is decreased in the country. Therefore, general price level has increased.

(8) Nationalization of Industries:

Due to nationalization of industries in different countries, the investor's class is hesitated to do investment due to fear of nationalization. So in this way production capacity is decreased in the country and prices have increased.

(9) Construction of Houses:

In less developed countries, the people spend their savings on the purchase and construction of houses. So this unproductive expenditure also contributes towards inflation.

(10) Consumption Habits:

In Pakistan, urban population particularly feels proud in spending money on those items, which are commonly used in the advanced countries. So there is also a demonstration effect in Pakistan which results in the consumption of savings on non-productive items. Due to this the productive activities remain low.

(11) Foreign Aid:

The volume of foreign aid is also increasing with the passage of time in less developed countries. When this aid is used inside the country, it increases the inflation.

(12) Increase in Indirect Taxation:

The government is increasing the indirect taxes on goods every year. These indirect taxes have also increased the prices of goods.

(13) Rising prices of Imported Goods:

Different commodities are imported whose prices are rising in the international market. So these commodities also bring inflation when they are used in the country.

(14) Wars:

Inflation is natural in the period of war. The supply of consumer goods falls greatly due to decrease in production, which brings inflation.

(15) Foreign Inflation:

The foreign inflation travels to a country via exports, imports, exchange of services and capital movements. For example, the international persistent inflation started in the early 1970s traveled almost to every country.

MEASURES TO REMOVE INFLATION

The following are the remedies or measures for removing inflation:

(1) Restriction on the Import of Luxury Items:

The import of luxury items must be restricted. It will protect from international inflation and will be favourable for the balance of payments.

(2) Cut on Expenditure:

There should be a cut on the non-productive expenditure not only by government but also by the people.

(3) Denationalization:

Nationalized industries should be denationalized and private sector should be allowed to play its role more effectively.

(4) Change in Taxation System:

The taxation system should be revised in order to encourage the private sector by giving tax concession or rebate or by charging low rate of taxes on consumer goods.

(5) Sick Industries Problems:

Sick industries should be handed over to private sector to promote their efficiency or productivity.

(6) Market Mechanism:

Market mechanism should be allowed to function and there should be no fixation of prices.

(7) Check on Unplanned Cities:

The unplanned and unregulated growth of cities should be checked which would put a check on inflation.

(8) Effective Administration:

The administration should be made effective and alert to increase the output of the country.

(9) Discipline:

Discipline should be restored in factories and offices to improve the efficiency and output of the country.

(10) Coordination Between Monetary and Fiscal Policy:

Government should coordinate the monetary and fiscal policy in such a manner that it could check the inflation.

QUESTION NO. 2

DEFINITIONS:

(i) ***"The trade cycle is an alternation of period of prosperity and depression of good and bad trade".***

(Haberler)

(ii) ***"The trade cycle is a fluctuation in employment, output and prices".***

(A.H. Hanson)

PHASES OF TRADE CYCLE

(1) EXPANSION OR BOOM:

In this phase economic activities increase production, prices, employment, wages, interest rate, profit volume of credit and investment. New plants and factories are setup and old ones are fully utilized. Demand for labour increases and there is increase in the volume of profit.

Note: *It is not necessary that boom should reach the level of full employment.*

(CHARACTERISTICS)

(i) Level of full employment is achieved.

(ii) Cost of production increases due to increase in wage rate.

(iii) The volume of investment reaches its peak point.

(iv) New factories and plants are established.

(v) All sectors of economy produce goods and services with full capacity.

(2) RECESSION:

In this phase the costs begin to increase than the prices. Because the less efficient factors of production are employed at higher costs, the profit begins to disappear. A wave of pessimism and uncertainty prevails in the business. There is a fall in the production, investment and employment. Even the businessman closes the business. The recession phase comes to an end and goes into depression.

(CHARACTERISTICS)

(i) Cost of production increases as compared to prices.

(ii) Expected profit of producer begins to fall.

(iii) Aggregate investment trends to fall.

(iv) Output and income level also decline.

(v) A wave of pessimism and uncertainty prevails the business.

(3) DEPRESSION OF CONTRACTION:

In the period of depression economic activities are low and there is a fall in national income, employment and production. The costs are relatively higher than prices. Profit falls and there is a reduction in the consumer and capital goods. Producer suffers loss and demand for bank credit also falls. Effective demand and savings remain low.

(CHARACTERISTICS)

(i) The volume of production and trade decreases.

(ii) The level of income wages, profits falls.

(iii) Demand for goods and services shrinks.

(iv) Production of capital goods comes to an end.

(v) There is general tendency of contraction in credit and investment.

(4) RECOVERY OR REVIVAL:

During this period constructional and development the government starts works. In this period depression is removed and there is the beginning of boom and expansion. There is complete harmony between cost and price. Profit begins to reappear in the business. The repairs and replacement of capital equipments start. There is a gradual reemployment of labour. The commercial banks also expand the credit. The marginal efficiency of capital begins to rise and rate of investment increases. **According to Samuelson,** "Business conditions never stand still prosperity is followed by panic".

(CHARACTERISTICS)

(i) The consumers increase their expenditures and the demand for consumer goods begins to increase.

(ii) Producers expand their plants and machinery to produce goods and services.

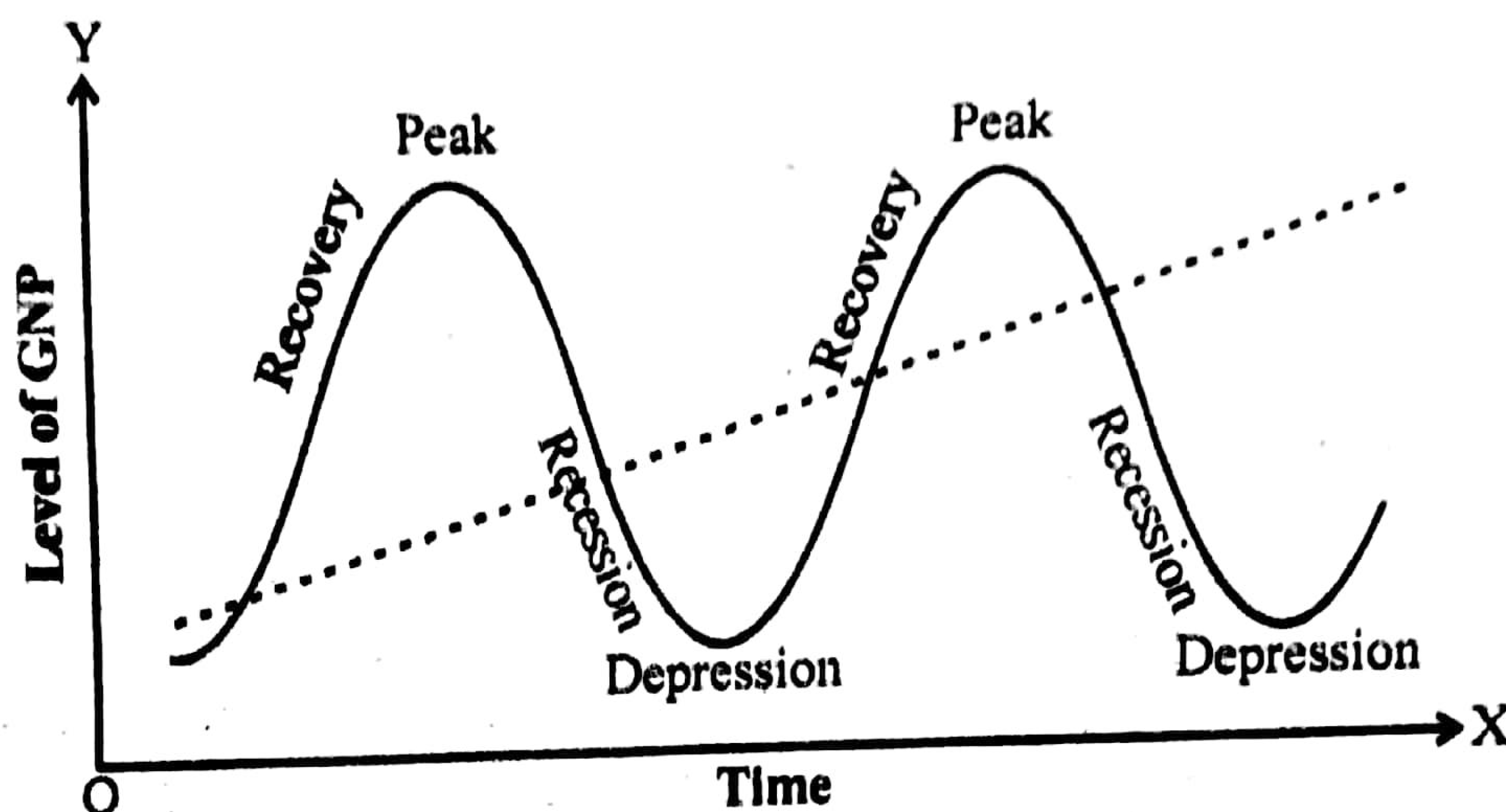
(iii) Level of employment gradually increases.

(iv) Rewards of factors of production increase as a result NI and per capita income also move up.

(v) Quantity of money and its velocity increases.

PHRASES OF TRADE CYCLE

Professor Marshal has explained the trade cycle by the help of following diagram:



QUESTION NO. 3

CREDIT CREATION

According to Prof. Crowther:

"The important work of bank is to provide easy medium of exchange for this payment and receipt to people. Banks are considered as manufacturer of credit. It means they are not only the dealer of money but in actual meaning they are the creator of credit".

As Hartly said *"Loans create deposits and deposits create loans"*.

WAYS OF CREDIT CREATION:

The single bank cannot create credit. It is the banking system as a whole, which can expand loans many times of its excess cash reserves. Commercial banks can create credit in following three ways:

(1) Discounting of Bills:

A bank also creates credit through discounting of bills of exchange. In this method the bank discounts the bill and issues a chequebook after the opening of account for the amount of discounted bill instead of giving cash.

(2) Supply of Loans:

When a bank agrees to grant loan to a borrower against the securities then it opens an account of the borrower for the granted amount of loan instead of giving cash. If the borrower wants to make payment to another person then it issues the cheque, which is deposited by the receiver into another bank. In this way the process of credit creation goes on.

(3) By Making Investments:

A bank also creates credit by making investment in securities. It buys securities from stock exchange and then credits the amount in the account of the seller or it pays a crossed cheque to the seller, which he can collect by depositing it into his bank account.

PROCESS OF CREDIT CREATION

For the explanation purpose we have to take the following **assumptions**:

(1) Primary (new) Deposit Rs. 2000.

(2) All the payments and receipts are made through banks or cheques.

(3) There is no leakage in the credit creation.

(4) The central bank does not adopt any credit control policy.

(5) Ratio of cash reserve is 20%, which remains constant through all the stages of the credit creation process.

Explanation:

A customer deposits Rs. 2000 in Bank A. Now Bank A grants loan of Rs. 1600 to another customer after keeping Rs. 400 (20 %) as reserve. The customer deposits the amount of loan (Rs. 1600) in its bank B. Now the bank will grant Rs. 1280 as loan after keeping Rs. 320 (20 %) as reserve. This is how a chain process of credit creation takes place.

The effect of credit creation process on the balance sheets of the banks is explained below:

[Initial Balance Sheet of Bank 'A']

Assets	(Rs.)	Liabilities	(Rs.)
Cash	2,000	Deposits	2,000
Total	**2,000**	**Total**	**2,000**

[Final Balance Sheet of Bank 'A']

Assets	(Rs.)	Liabilities	(Rs.)
Cash (Reserve)	400	Deposits	2,000
Loans Given	1,600		
Total	**2,000**	**Total**	**2,000**

The final balance sheet shows that the bank 'A' advances Rs. 1,600 (80% of its deposits) as loan and keeps Rs. 400 (20% of its deposits) as reserve.

The loan of Rs. 1,600 is deposited by the customer in bank 'B', whose initial and final balance sheets are as under:

[Initial Balance Sheet of Bank 'B']

Assets	(Rs.)	Liabilities	(Rs.)
Cash	1,600	Deposits	1,600
Total	**1,600**	**Total**	**1,600**

[Final Balance Sheet of Bank 'B']

Assets	(Rs.)	Liabilities	(Rs.)
Cash (Reserve) Loans Given	320 1,280	Deposits	1,600
Total	1,600	Total	1,600

The final balance sheet of bank 'B' shows that the bank keeps 20% (Rs. 320) as cash reserve and lends the remaining 80% (Rs. 1,280) to the customer.

This loan of Rs. 1,280 is deposited by the customer in bank 'C'. The initial and final balance sheets of bank 'C' are as under:

[Initial Balance Sheet of Bank 'C']

Assets	(Rs.)	Liabilities	(Rs.)
Cash	1,280	Deposits	1,280
Total	**1,280**	**Total**	**1,280**

[Final Balance Sheet of Bank 'C']

Assets	(Rs.)	Liabilities	(Rs.)
Cash (Reserve) Loans Given	256 1,024	Deposits	1,280
Total	**1,280**	**Total**	**1,280**

The final balance sheet of bank 'C' shows that the bank keeps 20% (Rs. 256) as cash reserve and lends the remaining 80% (Rs. 1,024) to the customer.

This process will go on to other banks till the last deposit is too small to generate any further loan.

FORMULA OF CREDIT CREATION

If we want to know the expansion of credit for Rs. 2000 the following formula can be applied or used:

$$\text{Total deposit} = \text{Primary (new) deposit} \times \frac{1}{\text{Reverse ratio}}$$

$$= 2000 \times \frac{1}{20\ \%}$$

$$= 2000 \times \frac{100}{20} = \text{Rs. } 10{,}000$$

$$\text{Created deposits (credit creation)} = \text{Total deposit} - \text{Primary deposit}$$

$$= 10{,}000 - 2{,}000$$

$$= \text{Rs. } 8{,}000$$

Note: *Crowther in his book "An outline of money" said, "credit creation is a process of whole banking system and a single bank cannot perform it".*

LIMITATIONS OF CREDIT CREATION

The power of commercial banks to create credit is not unlimited. There are many limitations on the power of banks for the creation of credit:

(1) Cash Reserve:

A bank cannot lend all of its funds. It has to keep a reasonable portion of its funds to meet the demand of its customers (depositors). If more funds are required to meet the demand of depositors then the power of credit creation will be lower.

(2) Central Bank Policy:

The commercial banks are not independent in connection with lending. The central bank of the country can impose certain restrictions on banks to create credit or to extend loans by credit control measures.

(3) Willingness to Borrow:

If the people are not willing to borrow then credit cannot be created. It means the bank has to find customers in order to extend credit.

(4) Habit of Customers:

If the borrowers get the loan in cash and make the payments in cash instead of cheques then the banks cannot create the credit. So use of cheques is necessary for multiple credit expansion.

(5) Shortage of Securities:

Banks demand the securities from borrowers at the time of granting loan. If the borrower is not in a position to fulfill this requirement then the bank will not grant loan.

(6) Primary Deposits:

Banks can create credit only if they get primary (new) deposits that is why it is said that "deposits create credit and credit creates deposits".

(7) Political Condition:

If the country is politically stable then there are more chances of credit creation. While in case of political disturbance the people hesitate to invest or to obtain loan, which stops the process of credit creation.

(8) Economic Conditions:

If there is economic stability in the country, then there will be more chances of profit for traders. As a result, the traders get loans from banks and credit expands. In other words people do not take loans, if the economy is passing through depression.

QUESTION NO. 4

See Paper 2015 Question No. 7

QUESTION NO. 5

See Paper 2014 Question No. 5

QUESTION NO. 6

COMMERCIAL LETTERS OF CREDIT

DEFINITIONS:

(i) ***"The letter of credit is a written instrument issued by the buyer's bank authorizing the seller to draw in accordance with certain terms and conditions".***

(Frank Henious)

(ii) ***"The letter of credit is a commitment on the part of the buyer's bank to pay or accept draft drawn upon it provided such drafts do not exceed a specified amount".***

(Pritchard)

PARTIES OF LETTER OF CREDIT

The commercial L.C. has the following parties:

(1) Importer:

The person who buys goods from a foreign country is called importer.

(2) Exporter:

The person who sells goods to another country is called exporter. The L.C. is opened or issued is his favour.

(3) Importer's Bank:

It is the bank, which issues the L.C. and assures the exporter's bank for the payment. It is also called an issuing bank or buyer's bank or opening bank.

(4) Exporter's Bank:

It is the bank in whose name the L.C. is issued. This bank also advises the exporter for sending goods. It is also called advising bank or paying bank or negotiating bank.

OPENING OF LETTER OF CREDIT

Following are the stages to get a commercial L.C.

(1) Agreement:

First of all, the Importer and Exporter make an agreement for the purchase and sale of commodities or goods.

(2) Preparation of Documents:

After the agreement, the importer provides the following information in a form.

(i) Kind or type of commodities or goods.

(ii) Price of commodities or goods.

(iii) Quantity of commodities or goods

(iv) The mode of payment.

(3) **Contact with the Bank:**

After finalizing the agreement, the importer makes contact with the bank to open L.C.

(4) **Import License:**

The issuing bank or importer's bank while issuing LC requires the import license and the Performa invoice from the importer.

(5) **Application Form:**

If the bank is satisfied with the information provided by the importer then it provides him an application form in which all the essential points of the agreement are written.

(6) **Scrutiny of the Application:**

The bank scrutinizes the application, examines the customer's credit standing, the type of goods to be imported, the market demand of the goods, the collateral offered to cover the credit.

(7) **Under Taking from Importer:**

After accepting the application, the bank obtains an undertaking from the importer that he will buy all the documents from bank at the prescribed mark up fixed by the central bank.

(8) **Margin Requirement:**

The bank asks the importer to deposit a certain proportion of the total value of goods to be imported. Normally, the margin requirement may be up to 10 % to 40 %.

(9) **Issuance of L.C.:**

After getting satisfaction from all the information and documents provided by the importer, the bank issues a L.C. to Exporter's bank. Now both the traders can deal confidently because the banks have accepted the responsibility for the payment and receipt.

(10) **Confirmation:**

Firstly the L.C. is confirmed by fax or other telecommunications and then actual letter of credit is sent in writing to the beneficiary.

(11) **Delivery of Goods and Documents:**

The exporter delivers the goods after the confirmation of L.C. and his bank sends the concerned documents to the importer's bank.

(12) **Payment:**

The importer's bank clears the payment after examining documents in the light of agreement and then hands over all the documents to the importer after receiving the remaining amount in form of draft or cash.

QUESTION NO. 7

MODERN QUANTITY THEORY OF MONEY

INTRODUCTION:

Modern quantity theory of money was presented by Milton Friedman in his article "The Quantity Theory of Money – A Restatement" published in 1956. Friedman regards money in terms of other theory of consumer choice.

DEFINITION:

Money is a type of durable consumer good and people demand it for the services it performs and it is demanded as an asset or capital.

In Friedman's view the assets or wealth can be held in form of **money, bonds, shares, goods** and **human capital**. Demand for money depends upon the volume of total wealth and the relative return on different forms of assets which can be held as wealth. It means this quantity theory of money is just a theory of demand for money and not the theory of income, investment and employment.

[DETERMINANTS OF DEMAND FOR MONEY]

According to Milton Friedman, the demand for money or an asset is the function of the following factors.

(1) Return on Bonds:

If the rate of return on the bonds is higher in the market, the demand for money shall be smaller and vice versa.

(2) Return on Shares:

If the rate of return on shares is higher then people will prefer to keep their wealth in form of shares which decreases the demand for money and vice versa.

(3) Change in Prices:

If the prices are rising rapidly in a country, the demand for money shall be smaller and the people hold smaller amount of money to avoid a fall in the real purchasing power of the money.

(4) Degree of Risk:

The degree of risk about the return on an asset also affects the demand for assets. If the risk increases on an asset then its demand falls and demand for other alternative assets increases.

(5) Liquidity:

Liquidity means that how quickly an asset can be converted into cash. Keeping all other things constant, if the liquidity of an asset is higher then its demand will also be higher and vice versa.

EQUATION OF DEMAND FOR MONEY:

Based upon the factors discussed above, Milton Friedman developed the following equation of demand for money.

$$Md = f(U, P, Y, I, P^*)$$

Here:
- Md = Demand for money
- U = Utility of money
- Y = Level of income
- P = Price level
- I = Rate of interest
- P* = Inflation rate

Milton Friedman said that the utility of money normally remains same and he did not observe a severe type of inflation, which could influence the demand for money. So he deleted U and P* from his demand for money.

$$Md = f(P, Y, I)$$

BASIC FEATURES OF THE THEORY

- The demand for money is influenced by the change in the level of income and the relation between demand for money and level of income is non-proportional.
- The demand for money is influenced by the change in price level and there is a proportional relationship between price level and demand for money. According to Friedman's analyses, 1% increase in price level also leads to 1% increase in demand for money.
- The demand for money is influenced by change in the rate of interest and there is inverse relation between rate of interest and demand for money. If rate of interest increases the demand for money falls and vice versa.
- Money market is in equilibrium when "Md = Ms".
- If there is a change in a supply of money then Y, P and I also change and ultimately demand for money changes and eventually Ms becomes equal to Md.

[CRITICISM]

Milton Friedman theory has been criticized on the following grounds:

(1) Money Supply and Money GNP:

According to Friedman, there is a positive relationship between money supply and money GNP but in actual there is no correlation between them due to number of variables which cannot be controlled.

(2) Proportional Relationship:

Friedman observed proportional and direct relationship between price and demand for money but in actual it does not happen. The fact is that the demand for money is more than proportionately to change in the income level.

(3) Money is not Actually Goods:

If the income of a person increases, he increases his expenses on luxury goods. Since money is considered as a good by Friedman and according to his observation demand for luxury goods increases when the income of people in USA increases. Hence he treated money as luxury good but no such effects have been found in England.

(4) Certain Variables Ignored:

He ignored certain variables like price, output and rate of interest which may effect the supply of money.

(5) Wealth as Variable:

Friedman presented his revised demand function in 1982 in which he included wealth as variable alongwith income. According to him both the variables affect the demand for money. But it was criticized because income is a form of wealth and when income has been discussed earlier then there was no need to discuss wealth separately.

QUESTION NO. 8

(a) BANK RATE POLICY

This policy refers to the varying of the rate at which the central bank re-discounts the first class bills of exchange of scheduled banks or advances loans to them against approved securities. In case of inflation, the central bank increases the bank rate and vice versa.

(b) SPOT AND FORWARD EXCHANGE RATES

Spot Rate:

It means the rate of the moment prevailed in market. For example, if you go to currency dealer and ask him about exchange rate, the rate told by currency dealer is called spot rate.

Forward Rate:

Forward rate is related to future transactions or deliveries. In fact, forward rates provide hedge to an importer against loss due to devaluation of home currency. It means if an importer takes forward rate from bank due to fear of devaluation then the bank will provide the foreign currency on the decided (Forward) rate irrespective of the current exchange rate.

(c) MUSHARIKA

- It is an agreement between the bank and its client to participate in a business as temporary partners by providing agreed amount of funds for sharing profits or losses during a specified period of time.
- The client runs business under Musharika.
- The bank examines the feasibility and profit projection so as to monitor or supervise business transactions.
- The proportion of profit to be distributed between the participants must be agreed at the time of contract. If no proportion is decided then the contract is not valid.
- The loss is shared in the ratio of capitals provided by the participants.

(d) INDEX NUMBER

See Paper 2015 Question No. 3