ASSIGNMENT No. 01

Fundamental of Money and banking (8593) BS ACCOUNTING AND FINANCE

Spring, 2025

Q. 1 What is money? Explain the role and functions of money in a modern economy. (20)

Some people think that money arose as unit of account from customary ratios of exchange. There are others who hold that money originated as medium of exchange. This theory is more widely held and is generally believed that some articles general utility began to serve as a medium of exchange and became money. This was due to its general acceptability.

Throughout the history of civilization money has passed through different stages. Historically the development of money in the present form has evolved through the following stages. These stages are discussed as under.

Commodity money

The earliest money which came into use and was accepted in the exchange of goods was commodity money. A large number of item such as wheat, cotton, skins, arrows, bows, camels, goats etc have served as commodity money at different times and places depending upon the stage of development in that country. As time passed on it was found that these commodities were not best suited as general means of making payments.

The main problems with commodity money were that they lacked (a) durability (b) portability (c) divisibility (d) uniformity and standardization (e) regularity in supply (f) and had high opportunity cost, so search was made to find more suitable and convenient mean which is generally acceptable in payments for the goods and services. The search led to the discovery of precious metals like copper, silver and gold.

The word money has been taken from latin word "moneta" which denotes godess juno in whose temple money was minted in rome. At present the latin word pecunia is used for money. It is generally believed that pecunia is derived from pecus meaning cattle which have served at one time or another as a medium of exchange and a measure of value. People think that man done nothing to discover money but it appeared at its own according to the needs of circumstances. This idea is known as theory of spontaneous growth. According to some people money was discovered to overcome the defects of barter system. This idea is known as theory of evolution.

2. Metallic money

The next form of commodity money was the use of metals such as gold, silver, copper as medium of exchange. Such coins had in intrinsic value. Which was reflected in their face value? The use of un-coined metals as a medium of exchange created further difficulties; it became difficult for people to known the weight and value of the peiece of bullion at sight. The discovery of mines of gold and silver and their exhaustion caused fluctuations in the supply of money. Transaction and storage of precious metals also became dangerous. Debasement of metal further caused inconvenience and complications in exchange further advancement in the evolution of commodity money was the replacement of un-standardized metal ingnots with a standardized coinage. The metallic coins had a guaranteed weight of value by a competent authority. They had also the intrinsic value and so commanded a universal respect. With the passage of time these full bodied coins also proved a failure as a good medium of exchange. Coins were clipped abraded and melted down. They were also debased with the discovery or exhaustion of mines the intrinsic worth of the coins begins to depart from their face value efforts were made to find out a better unit of account.

Convertible paper money

In the evolution of money the next stage was the discovery of convertible paper money as a commodity money substitute. The convertible paper money is paper money that may be redeemed for a specific commodity at a rate of specialized on the currency. Before 1914 the bulk of bank notes were convertible into gold. The bank notes of various denominations had a promise by the bank to pay to the bearer as specific amount of gold on demand. The practice of exchanging paper currency for gold was eliminated after 1914 in england and in 1933 in usa. In today's economy the paper notes are inconvertible notes. They are neither fully nor fractionally convertible into gold. The paper money developed into inconvertible money is called flat money.

4. Flat money

Flat money consists of paper money that derives its status as money from the power of the state. That money is money because government says it is money. It is not backed by promise to pay something of intrinsic value. It is accepted because government declares it legal tender. The creditors must accept it as a medium of exchange and as a payment for debts.

5. Credit money

Another most important component of money supply is the deposit money or credit money. Deposit money consists of deposits at bank and the financial institutions which are subject to withdrawal by cheques. In developed countries of the world 95% transactions are carried on with cheques. Cheques are a safe way of transferring the ownership of deposits in financial institutions. They are normally acceptable as medium of exchange.

6. Electronic banking

In all the developed and many developing countries of the world including pakistan the commercial banks have entered into an era of electronic banking. The customers of banks having deposits in their accounts can make purchase, pay bills, transfer money simple by electronic signals.

7. Near money

The final stage in evolution of money has been the use of bills of exchange, treasury bills, debentures, saving certificates etc. They are known as near money. They are close substitute for money and are liquid assets. The final stage of its evolution has become intangible. Its ownership ins now transferable simply by book entry.
Why does the typical million-dollar lottery winner end up broke within three years after earning his or her millions? Because while they had a sudden windfall of money, they had no concept of wealth. Wealth is not the same thing as money. Wealth is not measured by the size of income. Wealth is measured in time.

Wealth is not the same thing as money. Wealth is not measured by the size of income. If all I have to my name is $1,000 in savings and checking combined, and my living expenses are $100 a day, then my wealth equals ten days. (i.e. Wealth is the ability to survive so many number of days forward.)

Actually, let's deepen that definition. Wealth is measured by the richness of your life experience today plus the number of days into the future that you have the capacity to continue living at that level of experience. One reason the rich get richer is that the rich work for a different kind of money. They don't work to generate income—they work to build wealth. There is a vast difference between the two.

When most people hear the word "wealth," money immediately comes to mind. There are wealth management firms like mine, overseeing trillions of dollars of assets under management. There are shows, podcasts, books, and magazines galore touting how to build your wealth through the latest investment trends. Even those in pursuit of balance preach healthy and wealthy, as if they are two distinctly separate goals. The world is conditioned to associate wealth with being rich.

The etymology of the word “wealth” comes from the Old English word “weal,” which refers to a state of well-being. Even going back to the Bible, weal is often referenced as a sound or healthy state. Notice that nowhere is there mention of money, investing, or finance.

It’s worth exploring the crossover point in which well-being came to mean financially successful. The connection isn’t by happenstance, finances certainly carry enormous weight in affecting the prosperity of a person, household, business, or government. But wealth is a state of mind, a unique personal definition, the sum of countless variables, of which money is but one.

3 reasons you should disconnect wealth and money

Having personally advised thousands of professionals from all walks of life over the past 15 years, I can vouch for the power money wields over its pursuers. While those who do not respect or care about their finances are bound for disaster, people on the other end of the spectrum risk another type of demise. The United States has been the richest country in the world for decades, yet according to the World Health Organization (WHO) has long been one of the most depressed countries, in terms of mental and behavioral disorders.

There are studies that show once a certain income threshold is crossed, increases in income are correlated to decreases in mental health. Some might argue that when one doesn’t have problems, they must think up problems (i.e., the real financial problem is eliminated so a novel mental one is created). However, it can’t be ignored that chasing money for the sake of itself can require important sacrifices in real well-being, only leading to a sense of emptiness once the monetary goal is reached.

Other side effects of putting money on the top pedestal can include poor work performance. The philosophy of care every company hopes to practice with their employees or customers can be shoved aside to make or save a few more dollars. At worse, blind pursuit of money can lead one to take corrupt action. I often talk about the three I’s needed for career satisfaction (income, independence, and impact). When income is the only one that matters, people can get trapped in the wrong profession without any independence or impact to appreciate.

On the financial planning side, money is at the route of people falling prey to “keeping up with the Joneses.” The urge to showcase financial status in competition among peers can force one to live beyond their means and wreck their budget. Lastly, once money has taken full control, it can breed an irrational investor. This type of investor may constantly watch their portfolio and begin making short-term emotional choices that deviate from their original strategy.

Reason #2: Money takes time

Making money takes time. Time is considered the greatest asset of all—here today but gone tomorrow. There is only so much time in a day, in a week, and in a lifetime to balance relationships, hobbies, exercise, and health. The saying, “People can spend a lifetime wasting their health chasing their wealth, only to end up wasting their wealth chasing their health,” is partially true. If real wealth were the goal, this would not be the case. Money may not rhyme in that line, but it would be the correct choice of word.

More than two thousand years ago, Aristotle summed it up nicely in saying, “The life of money-making is one undertaken under compulsion, and wealth is evidently not the good we are seeking; for it is merely useful and for the sake of something else.” Perhaps including wealth was a mistake in the translation, but this famous quote underscores how a mound of currency and mound of dirt carry no different value until they can translate into some improvement in well-being.

Reason #3: Money dies on its own

Money is undoubtedly an integral part of wealth. But it only makes up one letter in "MICE" (Money, Ideology, Compromise, and Ego), the acronym that governs human motivation. Similarly, it provides context around the price of every transaction, but hardly helps when evaluating the costs and values inherent to choices.

Money can't survive on its own, it needs somewhere to go, or it dies. There need to be goals to feed the balance sheet, to motivate workers, companies, and investors. As a financial advisor, when getting to know the goals of a client in our initial discovery, I don't think I've ever heard someone simply say, "I just want more money," and truly believe that was the life goal. The answers always involve goals such as retirement, funding college, buying a home, traveling, and other end results.

Economics invades every subject that matters, whether micro or macro. Money by itself has never solved issues like entitlements, education, tech, environment, war, and religion, but generating mutual wealth within these domains has routinely led to progress. So, just as investing is one part of financial planning, financial planning is one part of wealthy living.

Q. 2 What is inflation? Discuss the types of inflation and relevant remedies for reducing inflation. (20)

Inflation is a situation of rising prices in the economy.

A more exact definition of inflation is a sustained increase in the general price level in an economy. Inflation means an increase in the cost of living as the price of goods and services rise.
The rate of inflation measures the annual percentage change in the general price level.

Inflation and value of money

Inflation leads to a decline in the value of money. "Inflation means that your money won't buy as much today as you could yesterday. If the prices of goods rise, the same amount of money will purchase a smaller quantity of goods.

This diagram shows how inflation in the US has eroded the purchasing power of the dollar. The biggest decline in the purchasing power of the dollar occurred in the 1970s when inflation was highest.
Purchasing power of the Pound Sterling (1920=100)

1920	1930	1940	1950	1960	1970	1980	1990	1998
100	125	129	98	66	46	133	6.8	5.33

This table shows us that £100 buys fewer goods in 1998 than 1920, (approx 78% of its value)

Types of inflation

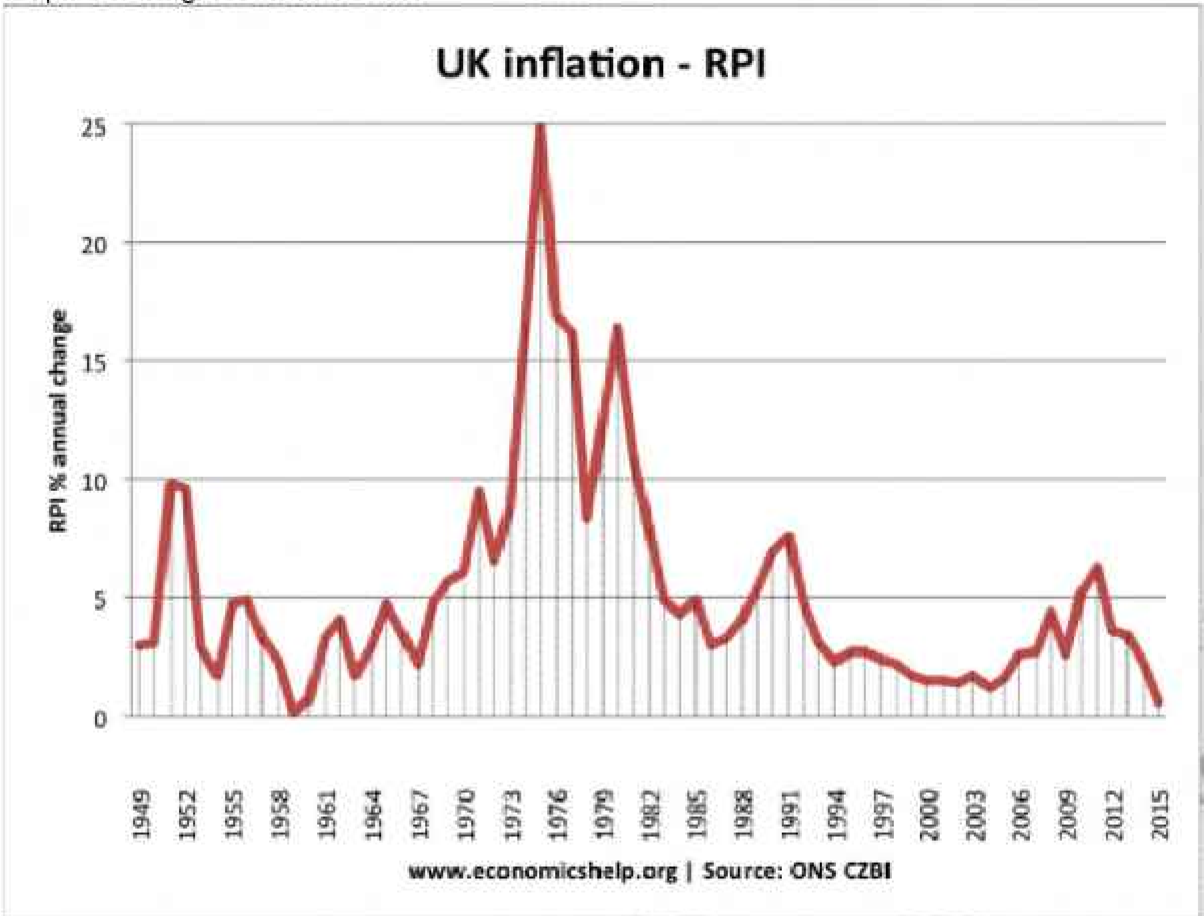
Cost-push inflation – when a rise in prices is caused by a rise in the cost of production, such as higher oil prices

Demand-pull inflation – when a rise in prices is caused by rising aggregate demand and firms pushing up prices due to the shortage of goods

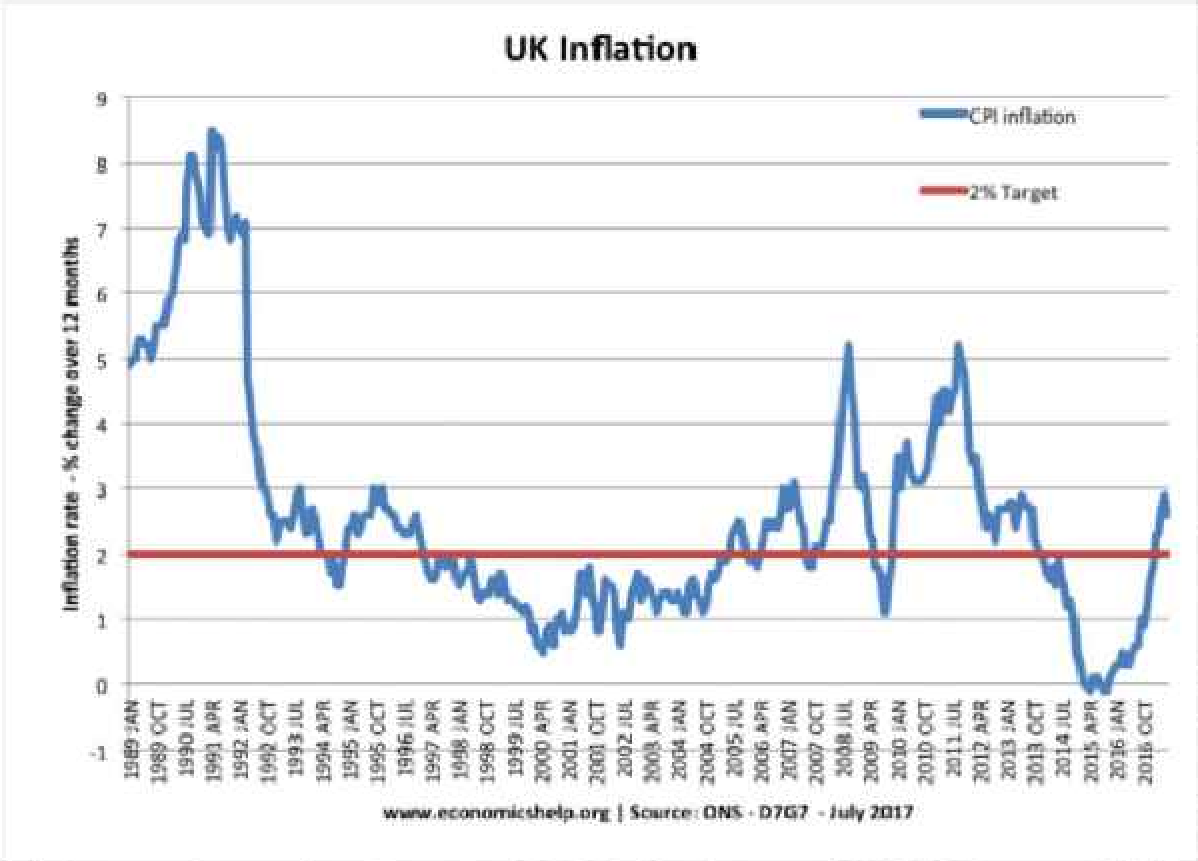
Definition Hyper-Inflation

Hyperinflation is generally considered to occur when inflation is greater than 1000%. With hyperinflation, money loses its value so rapidly that nobody wants to use it as a medium of exchange.
In 1920s Germany had inflation of 100 billion %
In 1946 Hungary had inflation of 42,000 billion per cent
See: Hyperinflation

Graph showing UK inflation rate



UK inflation in the post-war period.
In 1974, the inflation rate peaked at 25%. This was due to rising oil prices and rising wages.
In the late 1990s and early 2000s, the inflation rate fell to less than 2% in 2004.
This fall in the inflation rate means prices were increasing at a slower rate.
UK Inflation since 2000



Inflation was close to the governments target of 2% between 2000-2007
In 2008, inflation peaked at 5%, primarily because of a surge in the price of oil.
Inflation fell in 2009, because of the recession and fall in demand.
In mid-2015, there was a short period of deflation (negative inflation rate – falling prices)

Definition of Deflation

Deflation is a fall in the price level of the economy. It means there will be a negative inflation rate.
Measuring inflation

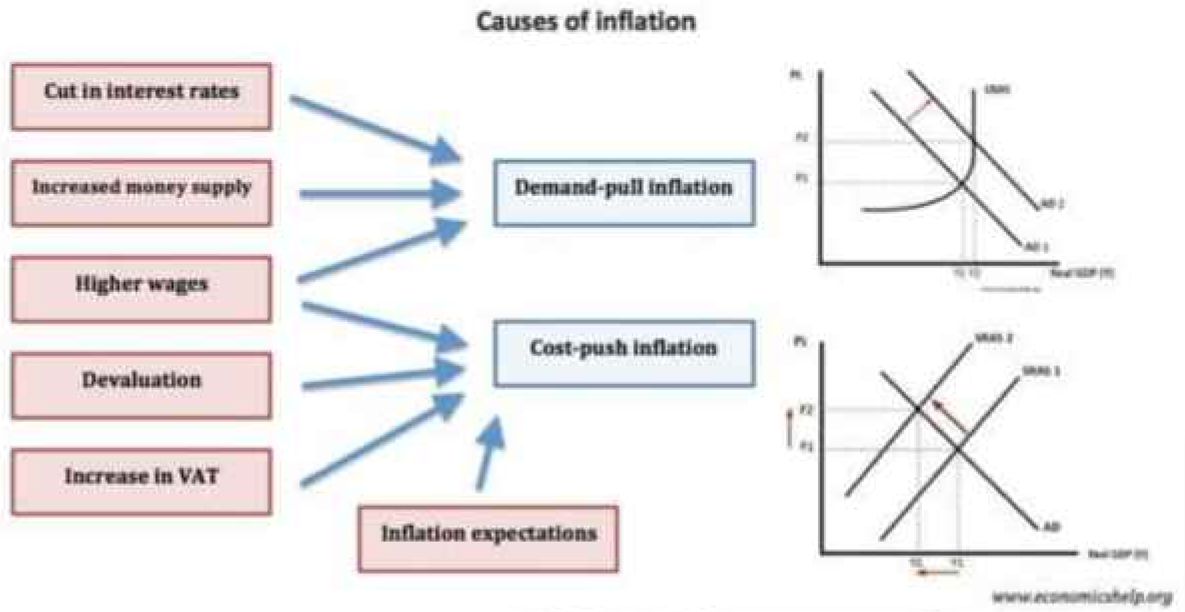
- To calculate inflation, the statistics authority (ONS)
- Measure the price of 1,000 goods every month
- Gives a weighting to different goods depending on how important they are in a typical basket of goods.
- An index is created with calculates the weighting of good * price change.

See more on Measuring inflation

Costs of inflation

- Inflation is seen to have economic costs. These include:
- A decline in value of savings
- Uncertainty for business leading to less investment.
- A decline in the competitiveness of exports (if inflation higher than in other countries.)
- See also: Costs of inflation

Causes of inflation



Inflation can be caused by:
Excess demand. Rapid economic growth causes firms to put up prices
Rising costs. For example, rising price of oil/commodities causes rise in price of goods.

Q. 3 What are the financial assets? Discuss their types with examples. (20)

Understanding Financial Assets

Financial assets are intangible assets that derive their value from contractual claims. These include stocks, bonds, bank deposits, and other instruments that represent ownership or a claim on future cash flows. Unlike physical assets, financial assets do not have inherent value but instead rely on the issuer's ability to meet financial obligations.

Types of Financial Assets

Financial assets come in various forms, including equity instruments like stocks, debt instruments like bonds, and hybrid instruments like convertible bonds. Each type serves different purposes for investors and issuers, providing a range of risk and return profiles to suit different financial goals.

Equity Instruments

Equity instruments, such as common and preferred stocks, represent ownership in a company. When you purchase a share, you own a portion of the company and are entitled to a share of the profits through dividends. Equity instruments are a key component of financial markets, enabling companies to raise capital by selling ownership stakes.

Debt Instruments

Debt instruments include bonds, loans, and other forms of borrowing. When you purchase a bond, you are lending money to the issuer in exchange for periodic interest payments and the return of the principal at maturity. Debt instruments are vital for both governments and corporations to finance large projects and operations.

Hybrid Instruments

Hybrid instruments combine features of both equity and debt. Convertible bonds, for example, are bonds that can be converted into a predetermined number of shares of the issuing company. These instruments offer investors the potential for capital appreciation while providing the safety of fixed interest payments.

Money Market Instruments

Money market instruments are short-term debt securities that typically mature in less than a year. These include Treasury bills, commercial paper, and certificates of deposit. Money market instruments are used by governments, financial institutions, and corporations to manage short-term liquidity needs.

Derivatives as Financial Assets

Derivatives are financial contracts whose value is derived from an underlying asset, such as stocks, bonds, commodities, or currencies. Common derivatives include options, futures, and swaps. These instruments are often used for hedging risks or speculative purposes in financial markets.

Role of Financial Assets in Capital Formation

Financial assets play a crucial role in capital formation, which is essential for economic growth. By issuing stocks and bonds, companies can raise the capital needed for expansion, innovation, and the development of new products and services. This capital formation drives job creation, productivity, and overall economic development.

Financial Assets and Wealth Accumulation

For individuals, financial assets are a primary means of accumulating wealth. Through investments in stocks, bonds, and other financial instruments, individuals can grow their savings over time, benefiting from capital gains, dividends, and interest payments. This wealth accumulation is vital for long-term financial security, retirement planning, and intergenerational wealth transfer.

Liquidity and Financial Assets

Liquidity refers to the ease with which financial assets can be converted into cash without significantly affecting their value. Financial assets like stocks and bonds are typically more liquid than physical assets like real estate. High liquidity in financial markets ensures that investors can quickly buy or sell assets, which promotes market efficiency and stability.

Risk Management through Financial Assets

Financial assets play a critical role in risk management. Investors can diversify their portfolios by holding a mix of stocks, bonds, and other assets, reducing exposure to any single asset's risk. Additionally, derivatives such as options and futures allow investors to hedge against potential losses in their portfolios.

Financial Assets and Interest Rates

Interest rates have a direct impact on the value of financial assets, particularly debt instruments like bonds. When interest rates rise, the value of existing bonds typically falls, and vice versa. Central banks use interest rate adjustments as a tool to influence economic activity, making the relationship between interest rates and financial assets crucial for both investors and policymakers.

Financial Assets and Economic Stability

Financial assets contribute to economic stability by providing mechanisms for saving and investment. Well-functioning financial markets allow for efficient allocation of resources, which supports economic growth and reduces the likelihood of financial crises. However, excessive speculation in financial assets can lead to bubbles and economic instability.

Inflation and Financial Assets

Inflation affects the real value of financial assets. While some financial assets, like stocks, may provide a hedge against inflation, others, such as fixed-income securities, may lose value as inflation erodes the purchasing power of future cash flows. Investors need to consider inflation risks when managing their portfolios.

Globalization and Financial Assets

Financial assets are increasingly global, with investors able to buy and sell assets in markets around the world. This globalization of financial markets allows for greater diversification and access to capital, but it also introduces new risks, such as currency fluctuations and political instability in foreign markets.

Technology and Financial Assets

Technology has revolutionized the trading and management of financial assets. Online trading platforms, algorithmic trading, and financial technology (fintech) have increased market access, reduced transaction costs, and provided new tools for managing investments. However, the rapid pace of technological change also introduces new challenges, such as cybersecurity risks.

Regulation of Financial Assets

Regulation plays a key role in ensuring the integrity and stability of financial markets. Governments and regulatory bodies oversee the issuance, trading, and disclosure practices related to financial assets to protect investors and maintain confidence in the financial system. Regulations are designed to prevent fraud, market manipulation, and systemic risks.

Financial Assets in Retirement Planning

Financial assets are central to retirement planning, providing individuals with the means to save and invest for their future. Retirement accounts, pensions, and other investment vehicles allow individuals to grow their wealth over time, ensuring financial security in retirement. The choice of financial assets in a retirement portfolio is crucial for balancing risk and return.

Social Impact of Financial Assets

Financial assets can also have a social impact through socially responsible investing (SRI) and environmental, social, and governance (ESG) criteria. Investors increasingly seek to align their investments with their values by supporting companies that prioritize sustainability, ethical practices, and social responsibility. This shift is influencing corporate behavior and driving positive change.

Financial Assets and Corporate Governance

Ownership of financial assets, particularly stocks, gives shareholders a voice in corporate governance. Shareholders can influence company decisions through voting rights, including decisions on executive compensation, corporate strategy, and social responsibility initiatives. Effective corporate governance ensures that companies are managed in the best interests of shareholders and stakeholders.

Challenges and Risks of Financial Assets

While financial assets offer numerous benefits, they also come with risks. Market volatility, interest rate changes, credit risk, and liquidity risk are some of the challenges investors face. Moreover, the complexity of some financial instruments, such as derivatives, can lead to misunderstandings and mismanagement, contributing to financial crises. Managing these risks is essential for maintaining the stability and confidence in financial markets.

The Future of Financial Assets in the Economy

As economies evolve, the role of financial assets will continue to grow. Innovations in fintech, the rise of digital currencies, and the increasing importance of sustainable investing are reshaping how financial assets are created, traded, and valued. Understanding these trends and their implications will be crucial for investors, policymakers, and businesses as they navigate the future of finance.

Q. 4 What are the financial markets? Briefly discuss the role of financial markets in an economy. (20)

Introduction: The Nervous System of the Economy

Financial markets are the essential backbone of any modern economy, acting as the conduits through which funds flow from those who have surplus capital (savers and investors) to those who need capital (borrowers and businesses). These markets, encompassing a wide array of institutions, instruments, and activities, facilitate the efficient allocation of resources, driving economic growth and stability. Understanding their functions is critical to grasping the overall health and dynamism of any nation's economic landscape. They operate as a crucial mechanism, enabling the transfer of wealth and the financing of economic activities. Without well-functioning financial markets, economic progress would be severely hampered. The diverse nature of these markets reflects the complex needs of a multifaceted economy, ensuring that various financial needs are met. They are the intermediaries that make possible the efficient flow of funds, contributing to overall economic prosperity.

2. Mobilizing Savings and Investments

Financial markets play a pivotal role in mobilizing savings, turning idle funds into productive investments. Individuals and institutions deposit their savings in banks, invest in stocks or bonds, or participate in other financial instruments. This collective pool of savings then becomes available to businesses and governments for investment projects, infrastructure development, and operational needs. Through this process, financial markets facilitate the efficient allocation of capital, ensuring that funds are directed towards the most promising and productive ventures. The savings mobilized are allocated to where they will generate the greatest return. This leads to higher levels of capital investment and contributes to economic expansion and job creation. Financial markets serve to channel savings towards their most productive uses, fueling economic growth. This efficient transfer of capital is essential for long-term economic development.

3. Facilitating Capital Formation

Capital formation, the process of accumulating physical and financial capital, is a crucial driver of economic growth. Financial markets provide the mechanisms through which businesses can raise capital for expansion, innovation, and the creation of new products and services. Through the issuance of stocks, bonds, and other financial instruments, companies can access funds from a diverse pool of investors. The markets provide mechanisms for raising capital and promoting economic expansion. This allows businesses to undertake new projects, develop new technologies, and create new jobs. Capital formation is a process that accelerates economic growth. Without access to these markets, it can be difficult for companies to grow. The efficient allocation of capital is dependent on the functionality of these markets.

4. Efficient Allocation of Resources

A key function of financial markets is to ensure the efficient allocation of resources within an economy. By channeling funds to their most productive uses, these markets promote economic efficiency and foster growth. Investors, guided by market prices and signals, evaluate the potential returns and risks associated with different investment opportunities. This information helps them make informed decisions about where to allocate their capital. The allocation of resources is a key function of financial markets. This process ensures capital flows toward the most promising ventures. This leads to higher levels of economic activity and increased productivity. Efficient allocation of resources reduces waste and promotes sustainable economic growth. This leads to a more efficient allocation of resources.

5. Risk Management and Hedging

Financial markets offer a range of instruments and strategies for managing and hedging risks. Businesses and investors face various risks, including interest rate fluctuations, currency exchange rate changes, and commodity price volatility. Financial markets provide tools such as derivatives, futures contracts, and options that enable participants to mitigate these risks. Derivatives allow entities to transfer the risk to those willing to bear it. Hedging allows people to protect the value of assets. Risk management is essential to the proper functioning of markets. These instruments allow participants to navigate uncertainty and make sound economic decisions. Risk mitigation contributes to economic stability.

6. Price Discovery and Information Efficiency

Financial markets act as platforms for price discovery, where the forces of supply and demand interact to establish the prices of financial assets. These prices reflect the collective expectations of market participants regarding the future prospects of companies, industries, and the overall economy. Market prices convey valuable information to investors and businesses, guiding their decisions about resource allocation. In addition, these markets facilitate the efficient dissemination of information. Prices reflect current information to those involved. This information is critical for making sound economic decisions. This information can assist in guiding economic decisions. This transparency is important for market efficiency.

7. Providing Liquidity

Liquidity, the ease with which an asset can be converted into cash without significant loss of value, is a crucial characteristic of well-functioning financial markets. These markets provide liquidity by offering a platform for the buying and selling of financial assets. Investors can quickly convert their investments into cash when they need it. This liquidity reduces transaction costs, encourages investment, and promotes market efficiency. The availability of a liquid market makes it easier for investors to adjust their portfolios. Liquidity is important for the stability of the financial system. This improves economic stability.

8. Reducing Transaction Costs

Financial markets help reduce transaction costs associated with the buying and selling of financial assets. These costs include brokerage fees, bid-ask spreads, and search costs. By bringing together buyers and sellers in a centralized marketplace, financial markets lower these costs, making it easier and more efficient to trade. This helps reduce the cost of doing business and promotes the efficiency of the economy. Lowering transaction costs encourages greater participation. These help in increasing economic activity. This promotes economic development.

9. Corporate Governance and Monitoring

Financial markets play a role in promoting corporate governance and monitoring the activities of companies. Investors, particularly institutional investors, have a vested interest in the performance of the companies they invest in. This often involves monitoring management, assessing financial performance, and exercising their voting rights to influence corporate decisions. Market scrutiny helps ensure that companies operate in the best interests of their shareholders. Financial markets provide the financial base for corporate governance. Corporate governance practices ultimately serve to protect investor interests. This, in turn, encourages the healthy growth of the economy. This promotes the sustainability of the economy.

10. Facilitating International Trade and Investment

Financial markets facilitate international trade and investment by providing mechanisms for currency exchange, cross-border capital flows, and the financing of international transactions. These markets allow businesses to engage in international trade and investment with reduced risk and greater efficiency. Financial markets help to ease international transactions. These markets promote globalization and economic integration. This leads to increased economic activity. International trade is a key component of a global economy. This helps promote economic growth.

11. Government Financing

Financial markets provide a vital source of funding for governments. Governments issue bonds and other debt instruments to finance public spending on infrastructure, social programs, and other essential services. The ability of governments to borrow at reasonable interest rates is crucial for maintaining fiscal stability and promoting economic growth. Government finance can be a key component of national growth. It also can serve as a driver for the economy. Without access to markets, borrowing costs will increase. They have great significance for the economy. They serve as a basis for financial growth.

12. Supporting Innovation and Entrepreneurship

Financial markets play an important role in supporting innovation and entrepreneurship by providing funding to new and growing businesses. Venture capital, angel investors, and initial public offerings (IPOs) are all mechanisms through which entrepreneurs can raise capital to launch and scale their businesses. These markets allow innovative ventures to access capital and bring new products and services to market. They facilitate the development of new industries. These markets support new and established business. These markets are crucial for economic growth.

13. Economic Signaling

Financial markets send important signals to businesses and policymakers about the state of the economy. Market prices, interest rates, and other financial indicators reflect the collective expectations of investors and provide valuable information about economic trends and risks. These signals help businesses make informed investment decisions and policymakers formulate appropriate monetary and fiscal policies. The signals provided can help guide the economic growth. These markets help to provide economic stability. The markets act as important indicators.

14. Diversification and Risk Sharing

Financial markets enable investors to diversify their portfolios, reducing their exposure to specific risks. By investing in a range of assets, investors can spread their risk and reduce the potential for losses. Diversification is an essential aspect of financial planning and risk management. Financial markets provide the opportunity to diversify. This decreases the risk of investment. This promotes the well-being of the economy. Diversification is important in the financial markets.

15. Creating Wealth and Promoting Economic Welfare

Financial markets contribute to wealth creation and promote overall economic welfare. By facilitating the efficient allocation of capital, supporting investment, and fostering innovation, these markets contribute to economic growth and job creation. Financial market are key to a good economy. These markets provide many wealth opportunities. This wealth helps increase economic welfare. These markets promote overall economic well-being.

16. Impact on Monetary Policy

Financial markets play a crucial role in the implementation of monetary policy. Central banks use various tools, such as interest rate adjustments and open market operations, to influence financial conditions and achieve their macroeconomic objectives. The effectiveness of monetary policy depends on the responsiveness of financial markets to these policy actions. The markets are linked to the federal reserve system. They depend on the monetary policy decisions. Monetary policy is a key tool for economic growth. This directly affects the economy.

17. Providing Information to Policymakers

Financial markets provide valuable information to policymakers about the state of the economy and investor sentiment. Market prices, trading volumes, and other financial indicators can provide early warning signals of potential economic problems. This information helps policymakers to monitor the economy and to make informed decisions. The markers signal when the economy is at risk. This helps to guide public policy decisions. This helps to provide economic stability. This can give a warning of problems.

18. Fostering Transparency and Disclosure

Financial markets foster transparency and disclosure by requiring companies to provide information about their financial performance, risk exposures, and corporate governance practices. This information helps investors to make informed decisions and promotes market efficiency. Transparency is vital for the proper operation of financial markets. It builds confidence in the markets. Transparency improves market integrity.

19. Challenges and Risks

While financial markets offer significant benefits, they also face challenges and risks, including market volatility, bubbles, and financial crises. These risks can arise from various factors, such as speculative behavior, excessive leverage, and inadequate regulation. These are risks that are always present. Regulatory bodies are vital to the proper functioning of the markets. Risks are inherent in financial markets.

20. The Importance of Regulation

Effective regulation is essential for the stability and efficiency of financial markets. Regulations can help to mitigate risks, protect investors, and promote transparency. Sound regulations help provide stability. Regulations are needed for the health of the financial markets. Regulation helps protect investors and consumers.

Q. 5 What is the role and functions of the IMF? Discuss in detail. (20)

If you have difficulty distinguishing the World Bank from the International Monetary Fund, you are not alone. Most people have only the vaguest idea of what these institutions do, and very few people indeed could, if pressed on the point, say why and how they differ. Even John Maynard Keynes, a founding father of the two institutions and considered by many the most brilliant economist of the twentieth century, admitted at the inaugural meeting of the International Monetary Fund that he was confused by the names: he thought the Fund should be called a bank, and the Bank should be called a fund. Confusion has reigned ever since.

Known collectively as the Bretton Woods Institutions after the remote village in New Hampshire, U.S.A., where they were founded by the delegates of 44 nations in July 1944, the Bank and the IMF are twin intergovernmental pillars supporting the structure of the world's economic and financial order. That there are two pillars rather than one is no accident. The international community was consciously trying to establish a division of labor in setting up the two agencies. Those who deal professionally with the IMF and Bank find them categorically distinct. To the rest of the world, the niceties of the division of labor are even more mysterious than are the activities of the two institutions.

Similarities between them do little to resolve the confusion. Superficially the Bank and IMF exhibit many common characteristics. Both are in a sense owned and directed by the governments of member nations. The People's Republic of China, by far the most populous state on earth, is a member, as is the world's largest industrial power (the United States). In fact, virtually every country on earth is a member of both institutions. Both institutions concern themselves with economic issues and concentrate their efforts on broadening and strengthening the economies of their member nations. Staff members of both the Bank and IMF often appear at international conferences, speaking the same recondite language of the economics and development professions, or are reported in the media to be negotiating involved and somewhat mystifying programs of economic adjustment with ministers of finance or other government officials. The two institutions hold joint annual meetings, which the news media cover extensively. Both have headquarters in Washington, D.C., where popular confusion over what they do and how they differ is about as pronounced as everywhere else. For many years both occupied the same building and even now, though located on opposite sides of a street very near the White House, they share a common library and other facilities, regularly exchange economic data, sometimes present joint seminars, daily hold informal meetings, and occasionally send out joint missions to member countries.
Despite these and other similarities, however, the Bank and the IMF remain distinct. The fundamental difference is this: the Bank is primarily a development institution; the IMF is a cooperative institution that seeks to maintain an orderly system of payments and receipts between nations. Each has a different purpose, a distinct structure, receives its funding from different sources, assists different categories of members, and strives to achieve distinct goals through methods peculiar to itself.

Purposes

At Bretton Woods the international community assigned to the World Bank the aims implied in its formal name, the International Bank for Reconstruction and Development (IBRD), giving it primary responsibility for financing economic development. The Bank's first loans were extended during the late 1940s to finance the reconstruction of the war-ravaged economies of Western Europe. When these nations recovered some measure of economic self-sufficiency, the Bank turned its attention to assisting the world's poorer nations, known as developing countries, to which it has since the 1940s loaned more than $330 billion. The World Bank has one central purpose: to promote economic and social progress in developing countries by helping to raise productivity so that their people may live a better and fuller life.

The international community assigned to the IMF a different purpose. In establishing the IMF, the world community was reacting to the unresolved financial problems instrumental in initiating and protracting the Great Depression of the 1930s: sudden, unpredictable variations in the exchange values of national currencies and a widespread disinclination among governments to allow their national currency to be exchanged for foreign currency. Set up as a voluntary and cooperative institution, the IMF attracts to its membership nations that are prepared, in a spirit of enlightened self-interest, to relinquish some measure of national sovereignty by abjuring practices injurious to the economic well-being of their fellow member nations. The rules of the institution, contained in the IMF's Articles of Agreement signed by all members, constitute a code of conduct. The code is simple: it requires members to allow their currency to be exchanged for foreign currencies freely and without restriction, to keep the IMF informed of changes they contemplate in financial and monetary policies that will affect fellow members' economies, and, to the extent possible, to modify these policies on the advice of the IMF to accommodate the needs of the entire membership. To help nations abide by the code of conduct, the IMF administers a pool of money from which members can borrow when they are in trouble. The IMF is not, however, primarily a lending institution as is the Bank. It is first and foremost an overseer of its members' monetary and exchange rate policies and a guardian of the code of conduct. Philosophically committed to the orderly and stable growth of the world economy, the IMF is an enemy of surprise. It receives frequent reports on members' economic policies and prospects, which it debates, comments on, and communicates to the entire membership so that other members may respond in full knowledge of the facts and a clear understanding of how their own domestic policies may affect other countries. The IMF is convinced that a fundamental condition for international prosperity is an orderly monetary system that will encourage trade, create jobs, expand economic activity, and raise living standards throughout the world. By its constitution the IMF is required to oversee and maintain this system, no more and no less.

Size and Structure

The IMF is small (about 2,300 staff members) and, unlike the World Bank, has no affiliates or subsidiaries. Most of its staff members work at headquarters in Washington, D.C., although three small offices are maintained in Paris, Geneva, and at the United Nations in New York. Its professional staff members are for the most part economists and financial experts.

The structure of the Bank is somewhat more complex. The World Bank itself comprises two major organizations: the International Bank for Reconstruction and Development and the International Development Association (IDA). Moreover, associated with, but legally and financially separate from the World Bank are the International Finance Corporation, which mobilizes funding for private enterprises in developing countries, the International Center for Settlement of Investment Disputes, and the Multilateral Guarantee Agency. With over 7,000 staff members, the World Bank Group is about three times as large as the IMF, and maintains about 40 offices throughout the world, although 95 percent of its staff work at its Washington, D.C., headquarters. The Bank employs a staff with an astonishing range of expertise: economists, engineers, urban planners, agronomists, statisticians, lawyers, portfolio managers, loan officers, project appraisers, as well as experts in telecommunications, water supply and sewerage, transportation, education, energy, rural development, population and health care, and other disciplines.

Source of Funding

The World Bank is an investment bank, intermediating between investors and recipients, borrowing from the one and lending to the other. Its owners are the governments of its 180 member nations with equity shares in the Bank, which were valued at about $176 billion in June 1995. The IBRD obtains most of the funds it lends to finance development by market borrowing through the issue of bonds (which carry an AAA rating because repayment is guaranteed by member governments) to individuals and private institutions in more than 100 countries. Its concessional loan associate, IDA, is largely financed by grants from donor nations. The Bank is a major borrower in the world's capital markets and the largest nonresident borrower in virtually all countries where its issues are sold. It also borrows money by selling bonds and notes directly to governments, their agencies, and central banks. The proceeds of these bond sales are lent in turn to developing countries at affordable rates of interest to help finance projects and policy reform programs that give promise of success.

Despite Lord Keynes's profession of confusion, the IMF is not a bank and does not intermediate between investors and recipients. Nevertheless, it has at its disposal significant resources, presently valued at over $215 billion. These resources come from quota subscriptions, or membership fees, paid in by the IMF's 182 member countries. Each member contributes to this pool of resources a certain amount of money proportionate to its economic size and strength (richer countries pay more, poorer less). While the Bank borrows and lends, the IMF is more like a credit union whose members have access to a common pool of resources (the sum total of their individual contributions) to assist them in times of need. Although under special and highly restrictive circumstances the IMF borrows from official entities (but not from private markets), it relies principally on its quota subscriptions to finance its operations. The adequacy of these resources is reviewed every five years.

Recipients of Funding

Neither wealthy countries nor private individuals borrow from the World Bank, which lends only to creditworthy governments of developing nations. The poorer the country, the more favorable the conditions under which it can borrow from the Bank. Developing countries whose per capita gross national product (GNP) exceeds $1,305 may borrow from the IBRD. (Per capita GNP, a less formidable term than it sounds, is a measure of wealth, obtained by dividing the value of goods and services produced in a country during one year by the number of people in that country.) These loans carry an interest rate slightly above the market rate at which the Bank itself borrows and must generally be repaid within 12-15 years. The IDA, on the other hand, lends only to governments of very poor developing nations whose per capita GNP is below $1,305, and in practice IDA loans go to countries with annual per capita incomes below $865. IDA loans are interest free and have a maturity of 35 or 40 years.

In contrast, all member nations, both wealthy and poor, have the right to financial assistance from the IMF. Maintaining an orderly and stable international monetary system requires all participants in that system to fulfill their financial obligations to other participants. Membership in the IMF gives to each country that experiences a shortage of foreign exchange--preventing it from fulfilling these obligations--temporary access to the IMF's pool of currencies to resolve this difficulty, usually referred to as a balance of payments problem. These problems are no respecter of economic size or level of per capita GNP, with the result that over the years almost all members of the IMF, from the smallest developing country to the largest industrial country, have at one time or other had recourse to the IMF and received from it financial assistance to tide them over difficult periods. Money received from the IMF must normally be repaid within three to five years, and in no case later than ten years. Interest rates are slightly below market rates, but are not so concessional as those assigned to the World Bank's IDA loans. Through the use of IMF resources, countries have been able to buy time to rectify economic policies and to restore growth without having to resort to actions damaging to other members' economies.

World Bank Operations

The World Bank exists to encourage poor countries to develop by providing them with technical assistance and funding for projects and policies that will realize the countries' economic potential. The Bank views development as a long-term, integrated endeavor.

During the first two decades of its existence, two thirds of the assistance provided by the Bank went to electric power and transportation projects. Although these so-called infrastructure projects remain important, the Bank has diversified its activities in recent years as it has gained experience with and acquired new insights into the development process.

The Bank gives particular attention to projects that can directly benefit the poorest people in developing countries. The direct involvement of the poorest in economic activity is being promoted through lending for agriculture and rural development, small-scale enterprises, and urban development. The Bank is helping the poor to be more productive and to gain access to such necessities as safe water and waste-disposal facilities, health care, family-planning assistance, nutrition, education, and housing. Within infrastructure projects there have also been changes. In transportation projects, greater attention is given to constructing farm-to-market roads. Rather than concentrating exclusively on cities, power projects increasingly provide lighting and power for villages and small farms. Industrial projects place greater emphasis on creating jobs in small enterprises. Labor-intensive construction is used where practical. In addition to electric power, the Bank is supporting development of oil, gas, coal, fuelwood, and biomass as alternative sources of energy.
The Bank provides most of its financial and technical assistance to developing countries by supporting specific projects. Although IBRD loans and IDA credits are made on different financial terms, the two institutions use the same standards in assessing the soundness of projects. The decision whether a project will receive IBRD or IDA financing depends on the economic condition of the country and not on the characteristics of the project.

Its borrowing member countries also look to the Bank as a source of technical assistance. By far the largest element of Bank-financed technical assistance--running over $1 billion a year recently--is that financed as a component of Bank loans or credits extended for other purposes. But the amount of Bank-financed technical assistance for free-standing loans and to prepare projects has also increased. The Bank serves as executing agency for technical assistance projects financed by the United Nations Development Program in agriculture and rural development, energy, and economic planning. In response to the economic climate in many of its member countries, the Bank is now emphasizing technical assistance for institutional development and macroeconomic policy formulation.

Every project supported by the Bank is designed in close collaboration with national governments and local agencies, and often in cooperation with other multilateral assistance organizations. Indeed, about half of all Bank-assisted projects also receive cofinancing from official sources, that is, governments, multilateral financial institutions, and export-credit agencies that directly finance the procurement of goods and services, and from private sources, such as commercial banks.
In making loans to developing countries, the Bank does not compete with other sources of finance. It assists only those projects for which the required capital is not available from other sources on reasonable terms. Through its work, the Bank seeks to strengthen the economies of borrowing nations so that they can graduate from reliance on Bank resources and meet their financial needs, on terms they can afford directly from conventional sources of capital.

The range of the Bank's activities is far broader than its lending operations. Since the Bank's lending decisions depend heavily on the economic condition of the borrowing country, the Bank carefully studies its economy and the needs of the sectors for which lending is contemplated. These analyses help in formulating an appropriate long-term development assistance strategy for the economy.

Graduation from the IBRD and IDA has occurred for many years. Of the 34 very poor countries that borrowed money from IDA during the earliest years, more than two dozen have made enough progress for them no longer to need IDA money, leaving that money available to other countries that joined the Bank more recently. Similarly, about 20 countries that formerly borrowed money from the IBRD no longer have to do so. An outstanding example is Japan. For a period of 14 years, it borrowed from the IBRD. Now, the IBRD borrows large sums in Japan.

IMF Operations

The IMF has gone through two distinct phases in its 50-year history. During the first phase, ending in 1973, the IMF oversaw the adoption of general convertibility among the major currencies, supervised a system of fixed exchange rates tied to the value of gold, and provided short-term financing to countries in need of a quick infusion of foreign exchange to keep their currencies at par value or to adjust to changing economic circumstances. Difficulties encountered in maintaining a system of fixed exchange rates gave rise to unstable monetary and financial conditions throughout the world and led the international community to reconsider how the IMF could most effectively function in a regime of flexible exchange rates. After five years of analysis and negotiation (1973-78), the IMF's second phase began with the amendment of its constitution in 1978, broadening its functions to enable it to grapple with the challenges that have arisen since the collapse of the par value system. These functions are three.

First, the IMF continues to urge its members to allow their national currencies to be exchanged without restriction for the currencies of other member countries. As of May 1996, 115 members had agreed to full convertibility of their national currencies. Second, in place of monitoring members' compliance with their obligations in a fixed exchange system, the IMF supervises economic policies that influence their balance of payments in the presently legalized flexible exchange rate environment. This supervision provides opportunities for an early warning of any exchange rate or balance of payments problem. In this, the IMF's role is principally advisory. It confers at regular intervals (usually once a year) with its members, analyzing their economic positions and apprising them of actual or potential problems arising from their policies, and keeps the entire membership informed of these developments. Third, the IMF continues to provide short- and medium-term financial assistance to member nations that run into temporary balance of payments difficulties. The financial assistance usually involves the provision by the IMF of convertible currencies to augment the afflicted member's dwindling foreign exchange reserves, but only in return for the government's promise to reform the economic policies that caused the balance of payments problem in the first place. The IMF sees its financial role in these cases not as subsidizing further deficits but as easing a country's painful transition to living within its means.

How in practice does the IMF assist its members? The key opening the door to IMF assistance is the member's balance of payments, the tally of its payments and receipts with other nations. Foreign payments should be in rough balance: a country ideally should take in just about what it pays out. When financial problems cause the price of a member's currency and the price of its goods to fall out of line, balance of payments difficulties are sure to follow. If this happens, the member country may, by virtue of the Articles of Agreement, apply to the IMF for assistance.

To illustrate, let us take the example of a small country whose economy is based on agriculture. For convenience in trade, the government of such a country generally pegs the domestic currency to a convertible currency: so many units of domestic money to a U.S. dollar or French franc. Unless the exchange rate is adjusted from time to time to take account of changes in relative prices, the domestic currency will tend to become overvalued, with an exchange rate, say, of one unit of domestic currency to one U.S. dollar, when relative prices might suggest that two units to one dollar is more realistic. Governments, however, often succumb to the temptation to tolerate overvaluation, because an overvalued currency makes imports cheaper than they would be if the currency were correctly priced.
The other side of the coin, unfortunately, is that overvaluation makes the country's exports more expensive and hence less attractive to foreign buyers. If the currency is thus overvalued, the country will eventually experience a fall-off in export earnings (exports are too expensive) and a rise in import expenditures (imports are apparently cheap and are bought on credit). In effect, the country is earning less, spending more, and going into debt, a predicament as unsustainable for a country as it is for any of us. Moreover, this situation is usually attended by a host of other economic ills for the country. Finding a diminished market for their export crops and receiving low prices from the government marketing board for produce consumed domestically, farmers either resort to illegal black market exports or lose the incentive to produce. Many of them abandon the farm to seek employment in overcrowded cities, where they become part of larger social and economic problems. Declining domestic agricultural productivity forces the government to use scarce foreign exchange reserves (scarce because export earnings are down) to buy food from abroad. The balance of payments becomes dangerously distorted.

As an IMF member, a country finding itself in this bind can turn to the IMF for consultative and financial assistance. In a collaborative effort, the country and the IMF can attempt to root out the causes of the payments imbalance by working out a comprehensive program that, depending on the particulars of the case, might include raising producer prices paid to farmers so as to encourage agricultural production and reverse migration to the cities, lowering interest rates to expand the supply of credit, and adjusting the currency to reflect the level of world prices, thereby discouraging imports and raising the competitiveness of exports.

Because reorganizing the economy to implement these reforms is disruptive and not without cost, the IMF will lend money to subsidize policy reforms during the period of transition. To ensure that this money is put to the most productive uses, the IMF closely monitors the country's economic progress during this time, providing technical assistance and further consultative services as needed.
In addition to assisting its members in this way, the IMF also helps by providing technical assistance in organizing central banks, establishing and reforming tax systems, and setting up agencies to gather and publish economic statistics. The IMF is also authorized to issue a special type of money, called the SDR, to provide its members with additional liquidity. Known technically as a fiduciary asset, the SDR can be retained by members as part of their monetary reserves or be used in place of national currencies in transactions with other members. To date the IMF has issued slightly over 21.4 billion SDRs, presently valued at about U.S. $30 billion.

Over the past few years, in response to an emerging interest by the world community to return to a more stable system of exchange rates that would reduce the present fluctuations in the values of currencies, the IMF has been strengthening its supervision of members' economic policies. Provisions exist in its Articles of Agreement that would allow the IMF to adopt a more active role, should the world community decide on stricter management of flexible exchange rates or even on a return to some system of stable exchange rates.

Measuring the success of the IMF's operations over the years is not easy, for much of the IMF's work consists in averting financial crises or in preventing their becoming worse. Most observers feel that merely to have contained the debt crisis of the 1980s, which posed the risk of collapse in the world's financial system, must be counted a success for the IMF. The Fund has also gained some recognition for assisting in setting up market-based economies in the countries of the former Soviet Union and for responding swiftly to the Mexican peso crisis in 1994, but its main contribution lies in its unobrusive, day-to-day encouragement of confidence in the international system. Nowhere will you find a bridge or a hospital built by the IMF, but the next time you buy a Japanese camera or drive a foreign car, or without difficulty exchange dollars or pounds for another currency while on holiday, you will be benefiting from the vast increase in foreign trade over the past 50 years and the widespread currency convertibility that would have been unimaginable without the world monetary system that the IMF was created to maintain.