LESSON 19

CENTRAL BANK: FUNCTIONS AND CREDIT CONTROL

Central Bank plays a pivotal role in regulating and controlling the banking and monetary system of all countries. It is responsible for a country's steady economic development, full employment, price stability and favourable balance of payment. The central bank issues directions to all banks and financial institutions. It is known as Federal Reserve Bank in America, Bank of England in England and Reserve Bank Of India in India. Central bank is an apex bank. **According to M.H. De Kock**- A central bank is "a bank which constitutes the apex of the monetary and banking structure of the country."

Definitions of Central Bank :-

Many scholars have attempted to define central bank from their point of view :-

According to A.C.L. Day- "A central bank is to help control and stabilise the monetary and banking system".

According to Samuelson- "A central bank is a bank of bankers. Its duty is to control the monetary base…and through control of this 'high powered money' to control the community's supply of money."

Thus, it is clear that central bank is apex institution in a country which is authorized to control the monetary and banking system.

In India, this role is played by Reserve Bank of India. It regulates the entire monetary and financial system of a country. It is empowered to issue currency notes, to issue authorization letter to the banking institutions. Thus, in a country it is known as apex bank or central bank.

Function of Central Bank:

Central bank performs the following functions-

1. It issues the currency notes.
2. It serves as Banker's bank and controller
3. It serves as a banker and advisor to the government.
4. It is the custodian of foreign exchange reserve.
5. Lender of the last resort
6. Central bank acts as a clearing house
7. Regulation and control of credit.

1. Issues the currency notes- The major function of central bank is to legally issue the currency notes. In India the Reserve Bank of India has the monopoly of issuing notes, to give uniformity in note and facilitates the exchange. Minimum reserve system is adopted to issue sufficient note currency in the country. A minimum fixed amount of gold and foreign currencies is to be kept against note issue by the Central Bank. Central Bank has direct control over the currency in circulation of a country.

> **Minimum Reserve System:** This system is operative in India whereby the Reserve Bank of India is required to keep 115 crores in gold and Rs. 85 Crores in foreign securities. There is no limit to issue of notes after keeping this minimum amount of Rs. 200 crores and minimum reserve in gold and foreign securities. In India in 1956 this system was adopted for issuing notes.

2. Banker's bank and controller:- Central bank regulates and controls all the financial activities of commercial banks. All the commercial banks are required by law to keep reserve equal to certain percentage of their total deposits with the central bank. To develop the banking system of the country, the central bank gives directions from time to time. It plays the role of decision maker in order to resolve any disputes among the banks. Central bank also grants protection to the rights of banking in a country.The Reserve Bank of India issues directives to the related banks on the grievances received from the customers.

3. Banker, Agent and Advisor to the Government:- Central bank in order to achieve high growth rate of a country, plays a cooperative role. It acts as an advisor in policy making for economic development . The central bank keeps the deposits of the government and makes the payment on behalf of the government. In India Reserve Bank as central bank plays a role of advisor of the government. The central bank announces the monetary policy of the country from time to time this purpose.

4. Custodian of foreign exchange reserve:- The central bank is custodian of foreign exchange reserves. Besides this, it also functions to increase these reserves. It collects foreign currency received from various sources and makes payment on behalf of the government. It tries to bring stability in foreign exchange rate for which tools like devaluation and revaluation are adopted. In India, this work is performed by central bank.

5. Lender of last resort:- In financial stringency, central bank plays the role of lender of last resort to its affilated banks. It lends to them immediately against their securities.

6. Clearing house for transfer and settlement:- Since Reserve Bank holds reserves of commercial banks, it performs the function of clearing house for its affiliated banks. It settles the mutual claims of commercial banks. It transfers funds from one to another without use of cash by making transfer entries in their accounts. It transfers the funds for commercial banks from one place to another. Thus, central bank by means of payment and funds transfer serves the functions of clearing house.

7.Regulation and Controller of credit:- Central bank performs the function of controlling both the supply of money and amount of credit money in country. The total quantity of money and its velocity directly influences inflation and deflation in a country. The central bank controls the supply of money in an economy keeping in view the goals of economic development. The central bank implements the monetary policy for the expansion and contraction of credit, which we will discuss later.

The most important of all the functions of the central bank is credit control. It is necessary to control the credit creation capacity of the commercial banks. The main objective of credit control by central bank is to overcome the instability like inflation and deflation, i.e. to maintain price stability in the country. Besides this, to stabilize the rate of foreign exchange, growth with stability and to provide quantity of credit according to trade of the country.

Methods of credit control by Central bank

Quantitative measures

1. Bank rate policy
2. Open market operations
3. CRR and SLR

Qualititative measures

1. Selective credit control
2. Rationing of credit
3. Moral presuasion
4. Publicity
5. Direct action

Quantitative Methods:-

The adoption of these measures has a direct effect on total quantity of credit without regard for the purpose for which credit is provided. They are used for controlling the total volume of credit but not the direction of flow of credit. Whenever in an economy of a country there is excess or scarcity of liquidity of money, then the measures adopted by central bank to check the volume of credit and its cost are called Quantitative Measures. The quantitative measures adopted in a developing country like India to control credit are as follows:-

1. Bank rate policy:- Bank rate is the most prevalent measure of credit control by the central bank. The credit potential of affiliated banks is directly affected with the use of this measure by central bank. "Bank rate is the rate at which central bank provide loans to the commercial banks."

Bank rate is the rate at which central bank rediscounts the bills of exchange held by commercial banks. In India, this function is performed by the RBI. When credit is to be contracted in the economy, then the central bank raises the bank rate which makes borrowing costly for the commercial banks, its credit potential also decreases. On contrary, if the need of the economy is to expand credit, it lowers the bank rate, the borrowing from central bank becomes cheap. So, commercial banks borrow more and advance more loans to its customers at lower rate.

2. Open Market operation:- The sale and purchase of government securities by the central bank is referred as open market operation. Central bank adopts this measure to regulate the volume of credit in an economy. If the central bank wants to control expansion of credit by commercial banks, it sells the government securities in the money market, the cash reserves of commercial banks decrease to the extent they purchase these securities. Hence, credit contracts conversely, when central bank purchases the securities in the open market, there is an increase in the commercial banks cash reserve, so they grant more loans, this leads to expansion of credit in an economy.

Cash Reserve Ratio (CRR) & Statutory Liquidity Ratio(SLR):-

The central bank uses both tools - the cash reserve ratio(CRR) and statutory liquidity ratio(SLR) for credit control. By law, banks have to keep a certain amount of liquid assets such as gold or approved securities as a percentage to total demand and time liabilities before providing credit to customers, is called Statutory Liquidity Ratio. Similarly by laws banks have to keep certain amount of cash as reserves ratio against total deposits is called cash reserve ratio. When central bank wants to do expansion of credit it lowers both the ratios and on contrary, when contraction of credit is desired then both the ratios are increased.

Qualititative Methods:

The selective or qualititative methods of credit control adopted by central bank is to regulate and limit the availability of credit to a specific sector of an economy. The aim of selective credit control is to channelize the flow of funds from unproductive sectors to productive (economically useful) sectors. The main types of selective measures of credit control are as follows:-

1. Selective credit control :- For specific sectors and specific requirments the central bank adopts the selective measures for credit control, which are as follows.

i. Changing the limits of loans

ii. Maintain difference in interest rates and discounting rate for bill of exchange

iii. Regulate grant of loans in specific sector

iv. Fixation of installment of luxury goods

2. Rationing of credit:- The central bank does the rationing of credit in different sectors i.e. margin or limits are determined by the bank. The rationing of credit is done by central bank by varying the minimum ratios.

- Variable portfolio ceiling - Central bank fixes a ceiling on portfolio of commercial banks, so loans do not exceed this ceiling.

- Variable capital assets ratio - Central bank may fixes minimum ratios regarding the capital of commercial bank to its total assets.

Besides the above measures, the central bank controls and regulates the credit by other measures, which are as follows:-

3. Moral persuation:- The central bank gives advise and directions to the commercial banks to regulate the credit creation by them. Central bank persuades and requests the commercial banks to cooperate in credit control policy. It is psychological and purely informal measure.

4. Publicity:- Advertisement has much importance in the age marketization. The central bank of every country publishes weekly or monthly statements, bulletins, journals and magazines etc. The aim is to make public aware of policies adopted by banks in the light of prevailing economic issues and challenges in the country. This measure of central bank also proves helpful in credit control.

5. Direct action:- The central bank is legally empowered to take direct action against the commercial banks if they fail to follow the above measures, or market failure conditions seem to appear. The central bank may refuse rediscount facilities to commercial bank, who does not follow the policy. It is most powerful measure of credit control which is not practically much used.

From the above discussion, it can be concluded that central bank for successful credit control appropriately, integrate and coordinate both quantitative and qualitative measures; where the quantitative measures directly influence the volume of credit and on the other hand the qualitative measures determine the direction of credit.

Reserve Bank of India

Reserve bank of India is the central bank of India.

It was established on 1 April 1935. Earlier its central office was established in Kolkata. Then in 1937, it was transferred to Mumbai untill then it was under private ownership. It was nationalized in 1949.

RBI is managed and directed by a Central Board of Directors which is as follows:-

Central Board of Directors

Governor

Deputy Governor

Executive Governor

Principal Chief General Manager

Chief General Manager

General Manager

Deputy General Manager

Asstt. General Manager

Manager

Asstt. Manager

Supporting Staff

Reserve Bank of India was established under the Reserve Bank of India Act, 1934.

According to the above Act, the working of Reserve Bank is governed by central board of directors. The government of India under the Reserve Bank of India Act appoints the board:

Constitution	-	Appointment of Board for 4 years
Government	-	Fulltime period
Director	-	One Governor & maximum four Deputy Governors
Non Government Director	-	Nominated by Government
	-	10 Directors in different areas and 2 government officers
	-	4 Directors - one from each Regional Board

Function of the Reserve Bank of India

The major functions performed by the Reserve Bank of India are as follows:

1. **Issuing currency notes:-** It issues currency notes with the objective that the public could get good quality currency notes in sufficient quantity. The currency of Reserve Bank of India is rupee of which symbol is **(₹)**. The currency and notes which do not remain suitable for circulation, are destroyed.

The one rupee note is issued by Ministry of Finance and it bears the signature of Finance secretary. The Reserve Bank of India issues the notes of the dinomination of it 2, 5, 10, 20, 50, 100, 200, 500 and 2000 Rs. Bears the signature of the governor of Reserve Bank of India.

Monetary Authorities:- It formulates the monetary policy for the economy of a country, it executes and regulates it. The main objective of monetary policy is to maintain price stability and provide sufficient loan to productive sector.

Regulator of financial sector:- The chief objective of central bank is to protect interest of the depositors and trust of the people in banking system. Besides this, with the objective to provide reasonable

Foreign Exchange Management:- Reserve bank under the foreign exchange management Act 1999, functions to facilitate external trade and facilitates payment of foreign exchange it also works for steady development of foreign exchange market.

Developmental role:- To achieve the national goals, Reserve Bank of India performs stimulating functions widely. It provides directions for development of various sectors, thus Reserve Bank makes the financial institutions financially strong.

Related functions:- Beside the above functions reserve bank performs many other functions also which are as follows:

Banker to a Government:- The Reserve Bank of India serves as a banker to the central government and state government. It grants economic help to the government of India at time of financial crisis.

Publication of information:- Reserve Bank publishes the confidential information regarding money, credit and economic condition of country. It also publishes annual, half yearly, quarterly and monthly bulletins.

Annual publications:- Report on Trends and Progress of Banking in India, Report on Currency and Finance, Handbook of Statistics on Indian Economy.

Monthly publication:- RBI Bulletin, Monetary and Credit Information Review.

Monetary policy of Reserve Bank of India

Monetary policy refers to the regulation and control of money and credit. In modern times, money and credit occupy an important place in economic progress of country. There is need of proper management and regulation of money and amount of credit in accordance with the monetary need of the country. In India, monetary policy is implemented after the recommendation of its central board. The principle tools of monetary policy of Reserve Bank are as follows:-

Repo rate:- It is the rate of interest at which RBI lends money to commercial banks for short term transactions. Central bank provides such loans for very short period; it is called 'overnight'. It increases the repo rate to decrease the liquidity with banks by use of this tool.

Reverse repo rate:- Interest rate offered by RBI to commercial bank for depositing their excess funds in the central bank. Reserve bank uses this instrument to limit the liquidity of the banks with increase in reverse repo rate, the rate of interest received on bank deposits increases resulting increase in bank deposits with reserve bank.

Cash Reserve Ratio(CRR):-Reserve Bank is an apex bank of all commercial banks. All the banks have to keep a certain amount of cash money as reserves against their deposits. This is called cash reserve ratio. An increase in cash reserve ratio leads to decrease of credit potential of its affiliated banks. There is contraction of credit in a country but when cash reserve ratio is reduced, it leads to expansion of credit in the economy of a country.

Statutory Liquidity Ratio(SLR):- The affiliated banks of reserve bank are required to maintain in form of fund(Gold, government approved securities) certain percentage to its total deposits which is called statutory liquidity ratio. Reserve bank expands the credit in a country by reduction of SLR, whereas on other hand to reduce the credit amount in a country it increases the SLR. Thus, in this way SLR is an important instrument of monetary policy of Reserve Bank of India.

The Reserve Bank has followed a targeted credit expansionary policy to achieve the objective of price stability and economic development.

Comparison of Central bank and Commercial banks:-

The central bank and commercial banks have crucial role in the economy of a country. The difference between central bank and commercial bank are found on the basis of objectives and functions. Both the institutions carry important responsibility in monetary and banking system of a country. The comparison between central bank and commercial banks on the basis of objectives and functions are as follows:

1. The chief objective of commercial bank is to earn profits whereas central bank's main objective is to control and regulate the banking system of a country.
2. Commercial banks provide short term and long term loans to their customers where as central

bank provide short and long term loans to government and commercial banks.

3. Commercial banks accept deposits from customer whereas central bank do not have direct transaction with the customer.

4. Commercial banks follow the monetary and credit policy implemented by the central bank whereas central bank serves as advisor to government and is banker of the banks.

5. In commercial banks, the customers can deposit the cash according to their will, but the commercial banks by law are required to keep certain percentage of their total deposits as reserves with the central bank.

In this way the commercial banks follow the directions given by central bank, thus cooperate in operating efficiently monetary and banking system of the country.

Important points

- The two primary functions of a central bank- is to issue of currency notes, Banker's bank and controller.
- Central bank is an apex banking institution of any country who is authorized to control the monetary and banking system.
- The adoption of these measures has a direct effect on total quantity of credit without regard for the purpose for which credit is provided.
- The selective or qualitative methods of credit control adopted by central bank is to regulate and limit the availability of credit to a specific sector of an economy.
- Bank rate is the rate at which central bank rediscounts the bills of exchange held by commercial bank.
- By law, banks have to keep a certain amount of liquid assets such as gold or approved securities as a percentage to total demand and time liabilities before providing credit to customers. is called statutory liquidity ratio(SLR).
- By law banks have to keep certain amount of cash in with themselves as reserves ratio against total deposits is called cash reserve ratio(CRR).
- The central bank does the rationing of credit in two ways (a) variable portfolio ceiling (b) variable capital asset ratio.
- The central bank is legally empowered to take direct action against the commercial banks if they fail to follow the above measures, or market failure conditions seem to appear. The central bank may refuse rediscount facilities to a commercial bank, who does not follow the policy.

Exercise Questions:

Objective Type questions :

1. Bank rate means-

(A) The rate at which commercial banks lends to central bank

(B) The rate at which central bank rediscounts the bills of commercial banks

(C) Rate at which moneylenders lend to the banks

(D) The rate at which banks lend to the public

2. Which of following is not the Qualitative Measure of credit control?

(A) Credit rationing

(B) Moral presuasion

(C) Open market operation

(D) Direct action

3. Which of the following is the main function of central bank?

(A) Issue of currency notes

(B) Accept deposits from the public

(C) Grant loan to public

(D) All of the above

4. The central bank of India is –

(A) State Bank of India

(B) Reserve Bank of India

(C) Union Bank

(D) Syndicate Bank

5. One rupee note bears the signature of-
   (A) Governor of RBI
   (B) Prime minister
   (C) Finance Secretary
   (D) Finance Minister

Very Short Answer Type Question:-

1. Define central bank.
2. What is meant by bank rate?
3. What do you understand by credit rationing?
4. Write the name of central bank of India.
5. Write the name of monthly bulletin issued by Reserve Bank of India.

Short Answer Type Questions:-

1. Explain the function of issuing currency notes of central bank.
2. Write the Quantitative Measures adopted for credit control by central bank.
3. Explain the measures of direct action by Central Bank.
4. Explain the central director board of RBI by means of a flow chart.
5. Write the names of at least four annual publications published by RBI.

Essay Type Question:-

1. Define central bank and explain its main functions in detail.
2. Explain in detail the measures adopted for credit control by central bank.
3. Explain in detail the monetary instruments of Reserve Bank of India.
4. Compare central and commercial bank on the basis of functions performed.

Answer Table

1	2	3	4	5
B	C	A	B	C