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ECONOMICS

UNIT-X

CENTRAL BANK & ITS FUNCTIONS

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UNIT-X-CENTRAL BANK & ITS FUNCTIONS

CREDIT AND COMMERCIAL BANKING

With the introduction and use of money credit also came into existence. Credit is created when one party (a person, a firm or an institution) lends money to another party, the borrower. The act of lending and borrowing creates both credit and debit. Whereas debt means the obligation to pay the finance borrowed, credit means the claim to receive this money payment from the other party.

The act of borrowing and lending and thereby creation of credit is a special type of exchange transaction which involves future payment of the principal sum borrowed as well as the rate of interest on it. In the modern times there are a variety of institutions which specialize in borrowing and lending of money. The bank credit is only one form of credit. Money lenders, indigenous bankers, credit co-operative societies, commercial and co-operative banks, industrial financial institutions, LIC, export finance houses, etc. are all credit institutions and do the borrowing and lending money.

A bank is an institution which accepts deposits from the public and in turn advances loans by creating credit. It is different from other financial institutions in that they cannot create credit though they may be accepting deposits and making advances.

A commercial bank is a business organization which deals money; it borrows and lends money. In this process of borrowing and lending of money it makes profit. The distinction between money lender and a commercial bank may be noted. Whereas a money lender only lends money to others and that too from his own sources, a commercial bank does both the lending and borrowing business. A commercial bank raises its resources through borrowing from the public in the form of deposits and lends them to the businessmen. Its lending rate of interest is greater than that it pays to its depositors. It is because of this difference in lending and borrowing rates of interest that it is able to make profit.

Functions of Commercial Banks

Commercial banks perform a variety of functions. They can be categorized as accepting deposits, advancing loans, credit creation, agency functions and miscellaneous functions.

1. **Accepting deposits**

The banks borrow in the form of deposits. This function is important because banks mainly depend on the funds deposited with them by the public. The deposits received by the banks can be of three types;

a)Demand or current account deposits: In this type of deposits the depositor can withdraw the money in part or in full at any time he likes without notice. These accounts are generally kept by the businessmen whose requirements of making business payments are quite uncertain. Usually, no interest is paid on them, because the bank cannot utilize these short term deposits and must keep almost cent percent reserve against them. But in return for these current account deposits, the banks offer some facilities or concession to the account holders. The most important is the cheque facility made available to them. Further, on behalf of the current account deposits, bank collects cheques, drafts, dividend warrants, postal orders, etc.

b)Fixed deposits or time deposits:

These deposits are made for a fixed period of time, which varies from fifteen days to a few years. These deposits cannot, therefore, be withdrawn before the expiry of that period. However, a loan can be taken from the bank against the security of this deposit within that period. A higher rate of interest is paid on the fixed deposits based on the period of the deposits.

c) Saving bank deposits:

In this case the depositor can withdraw money usually once a week. These deposits are generally made by the people of small means, usually people with fixed salaries, for holding short-term savings. Like the current account deposits, the saving bank deposits are payable on demand and also they can be drawn upon through cheques. But in order to discourage people to use the saving bank deposits very frequently, there are some restrictions on the number of times withdrawals can be made from these accounts. The saving deposits carry lower rate of interest than the fixed deposits.

2. **Advancing loans**

One of the primary functions of the commercial bank is to advance loans to its customers. A bank lends a certain percentage of the cash lying in deposits on a higher interest rate than it pays on such deposits. Thus the bank earns profits and carries on its business.

The bank advances loans in the following ways:

a) Cash credit :

The bank advances loan to businessmen against certain specified securities. The amount of loan is credited to the current account of the borrower. In the case of a new customer a loan account for the sum is opened. The borrower can withdraw money through cheques according to his requirements but pays interest on the full amount.

b) Call loans :

These are very short-term loans advanced to the bill brokers for not more than fifteen days. They are advanced against first class bill or securities. Such loans can be recalled at a very short notice. In normal times they can also be renewed.

c) Overdraft:

A bank often permits a businessmen to draw cheques for a sum greater than the balance lying in his current account. This is done by providing the overdraft facility up to a specific amount to the businessmen. But he is charged interest only on the amount by which his current account is actually overdrawn and not by the full amount of the overdraft sanctioned to him by the bank.

d) Discounting bills of exchange:

If a creditor holding a bill of exchange wants money immediately, the bank provides money by discounting the bill of exchange. It deposits the amount of the bill in the current account of the bill holder after deducting the rate of interest for the period of the loan which is not more than 90 days. When the bill of exchange matures, the bank gets its payment from the banker of the debtor who accepted the bill.

3. Credit creation

Credit creation is one of the most important functions of the commercial banks. Like other financial institutions, they aim at earning profits. For this purpose, they accept deposits and advance loans by keeping a small amount of cash as reserve for day-to-day transactions. When a bank advances a loan, it opens an account in the name of customer and does not pay him in cash but allows him to draw the money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.

3.Financing Foreign Trade

A commercial bank finances foreign trade of its customers by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and sells foreign currency.

4. Investment

It is obligatory for commercial banks to invest a part of their funds in approved securities. Other optional avenues of investments are also available. Investments in government securities are useful in two ways. One is that, the commercial banks can get income from their surplus funds. The other is that the liquidity, that is, encashability of securities is higher than that of loans.

5.Agency Services

Commercial bands act as an agent of its customers in collecting and paying cheques, bills of exchange, drafts, dividends, etc. It also buys and sells shares, securities, debentures, etc. for its customers. Further, it pays subscriptions, insurance premium, rent, electric and water bills, and other similar charges on behalf of its clients. It also acts as a trustee and executor of the property and will of its customers. Moreover, the bank acts as an income tax consultant to its clients. For some of these service, the bank charges a nominal fee while it renders others free of charge.

6.Miscellaneous Services

Besides the above noted services, the commercial bank performs a number of other services. It acts as a custodian of the valuables of its customers by providing them lockers where they can keep their jewellery and valuable documents. it issues various forms of credit instruments, such as cheques, drafts, travellers' cheques, etc. which facilitate transactions. The bank also issues letters of credit and acts as a referee to its clients. It underwrites shares and debentures of companies and helps in the collection of funds from the public. ATM stands for Automated Teller Machine. It is also depicted as Any Time Money as it provides the customers to withdraw money 24 hours subject to certain restrictions.

CENTRAL BANK

In the monetary system of all countries, the central bank occupies an important place. The central bank is the apex bank in a country. It is called by different names in different countries. It is the Reserve Bank of India in India (set up in 1935), the Bank of England in England, the Federal Reserve System in America, the Bank of France in France, etc.

Functions of a Central Bank

The following are the major functions of a central bank.

1. Note Issuing Agency

The central bank of the country has the monopoly of issuing notes or paper currency to the public. Therefore, the central bank of the country exercises control over the supply of currency in the country. In India with the exception of one rupee notes which are issued by the Ministry of Finance of the Government of India, the entire note is done by the Reserve Bank of India.

Central banks have been following different methods of note issue in different countries. The central bank is required by law to keep a certain amount of gold and foreign securities against the issue of notes. In some countries, the amount of gold and foreign securities bears a fixed proportion, between 25 to 40 per cent of the total notes issued. In other countries, a minimum fixed amount of gold and foreign currencies is required to be kept against note issue by the central bank. This system is operative in India whereby the Reserve Bank of India is required to keep Rs.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 in gold and foreign securities.

2. Banker to the Government

The central bank acts as a banker, agent and adviser to the government. It keeps the banking accounts of the government. All the balances of the government are kept with the central bank. But it pays no interest on these balances. Further, the central bank has to manage the public debt and also to arrange for the issue of new loans on behalf of the government. The central bank also provides short-term loans to the government. Thus it manages the public debt and advises the government on banking and financial matters.

3. Control of credit

The chief objective of the central bank is to maintain price and economic stability. For controlling inflationary and deflationary pressures in the economy the central bank adopts quantitative and qualitative measures of credit control. Quantitative methods aim at controlling the cost and quantity of credit by adopting bank rate policy, open market operations, and by variations in reserve ratios of commercial banks. Qualitative methods control the use and direction of credit. These involve selective credit controls and direct action.

4. Bankers' bank

The central bank acts as a bankers' bank in three capacities:

(a) as the custodian of the cash reserves of the commercial banks;

(b) as the lender of the last resort; and

(c) as bank of central clearance, settlement and transfers.

All other banks in the country are found by law to keep a fixed portion of their total deposits as reserves with the central bank. These reserves help the central bank to control the issue of credit by commercial banks. They in return can depend up on the central bank for support at the time of emergency. This help may be in the form of a loan on the strength of approved securities or through rediscounting of bills of exchange. Thus the central bank is the lender of last resort for other banks in difficult times.

In India, scheduled banks have to keep deposits with the Reserve Bank not less than 5% of their current demand deposits and 2% of their fixed deposits as reserves. In return they enjoy the privilege of rediscounting their bills with the Reserve Bank as well as securing loans against approved securities when needed.

Clearing function is also performed by the central bank for the banks. Since banks keep cash reserves with the central bank, settlement between them may be easily effected by means of debts and credits in the books of the central bank. If clearing go heavily against some bank, its cash reserves with the central bank will fall below the prescribed limit and therefore the bank concerned will have to make up the deficiency.

5. Lender of the last resort

The central bank helps the commercial banks when they face any difficulty. Even a well managed commercial bank can run into difficulty if there is a great rush of demand for cash by the depositors. During such occasions it will not be able to meet a sudden and large demand for cash. The central bank must therefore come to their rescue at such times. Thus the central bank is the last source of supply of credit.

6. Custody and Management of Foreign Exchange Reserves

The central bank keeps and manages the foreign exchange reserves of the country. An important function of a central bank is to maintain the exchange rate of the national currency. For example, the Reserve Bank of India has the responsibility of maintaining the exchange value of the rupee. When a country has adopted flexible exchange rate system under which value of a currency is determined by the demand for and supply of a currency, the value of a currency, that is, its exchange rate with other currencies is subject to large fluctuations which are harmful for the economy. Under these circumstances, it is the duty of the central bank to prevent undue depreciation or appreciation of the national currency. Since 1991 when the rupee has been floated, the value of Indian rupee, that is, its exchange rate with US dollar and other foreign currencies has been left to be determined by market forces. RBI has been taking several steps from time to time to stabilize the exchange rate of rupee, especially, in terms of US dollar.

There are several ways by which RBI can manage or maintain the exchange rate of the rupee.

(i) If due to speculative activities of foreign exchange operators, the rupee starts depreciating fastly, RBI can intervene in the market. It can use its reserves of dollars and supply dollars in the market from its own reserves. With the increase in the supply of dollars, the rupee will be prevented from depreciation. It may however be noted that the success of this step depends on the amounts of dollar reserves with RBI.

(ii) Another method by which RBI can manage the exchange rate of rupee is adopting measures which will reduce the demand for dollars. Some importers, foreign investors, foreign exchange operators try to avail of cheap credit facilities of banks and borrow rupee funds from the banks and try to convert them into dollars. This raises the demand for dollars and leads to the depreciation of the Indian rupee. Such a situation occurred in July-September, 1998. RBI intervened and raised the Cash Reserve Ratio (CRR) and increased its repurchase rates. This succeeded in mopping up the excess liquidity with the banks and reduced their lending capacity. This led to the reduction in the demand for dollars and helped in preventing the rupee from depreciating.

MONETARY POLICY

Monetary policy is an important instrument of economic policy to achieve multiple objectives. *Monetary policy is concerned with the measures taken to regulate the supply of money, the cost and availability of credit in the economy*. It also deals with the distribution of credit between uses and users and also with both the lending and borrowing rates of interest of the banks. In developed countries the monetary policy has been used for overcoming depression and inflation as an anti-cyclical policy. However, in developing countries it has to play a significant role in promoting economic growth.

It is important to understand the distinction between goals, targets and instruments of monetary policy. Whereas goals of monetary policy refer to the objectives such as price stability, full employment or economic growth, targets refer to the variables such as supply of money or bank credit, interest rates which are sought to be changed through the instruments of monetary policy so as to attain these objectives. The various instruments of monetary policy are changes in the supply of currency, variations in bank rates and other interest rates, open market operations, selective credit controls and variations in reserve requirements.

Instruments of Monetary Policy

The various instruments of monetary policy are;

1. Bank rate policy
2. Open market operations
3. Variable reserve ratio
4. Selective credit controls

1. Bank Rate Policy

Bank rate or rediscount rate is the rate fixed by the central bank at which it rediscounts the first class bills of exchange and government securities held by the commercial banks. The bank rate is the interest rate charged by the central bank at which it provides rediscount to banks. The central bank controls credit by making variations in the bank rate. When the economy needs to expand credit (during the periods of deficient demand), the central bank lowers the bank rate. Then borrowing from central bank becomes cheap. So the commercial banks will borrow more. They will, in turn, advance loans to customers at a lower rate. The market rate of interest will be reduced. This encourages business activity.

The opposite happens when credit to be contracted in the economy. The central bank raises the bank rate when the economy phases excess demand which makes borrowing costly from it. So the banks borrow less. They, in turn, raise their lending rates to customers. The market rate of interest also rises because of the tight money market. This discourages fresh loans. This leads to contraction of credit which depresses the rise in prices. Thus lowering the bank rate offsets deflationary tendencies and raising the bank rate controls inflation.

2. Open Market Operation

Open market operations are another quantitative method of credit control. This method refers to the sale and purchase of securities, bills and bonds of government and private financial institutions by the central bank.

There are two principal of open market operations. One, it influence the reserves of commercial banks in order to control their power of credit creation. Two, to affect the market rates of interest so as to control the commercial bank credit. In this method of credit control, when the central bank of a country wants to control expansion of credit by commercial banks for the purpose of controlling inflationary pressures within the country, it sells government securities in the money market. The purchasing power in the economy is reduced to the extent the commercial banks and individuals purchase government securities.

On the other hand, when the central bank aims at an expansionary policy during a recessionary period, it purchases government securities from the commercial banks and institutions dealing with such securities. The central bank pays the sellers of its cheques drawn against itself which are deposited into their accounts with the commercial banks. The reserves of the latter increase with the central bank which are just like cash. As a result the supply of bank money increases.

Another impact of the open market policy is that when the supply of money changes as a result of open market operations, the market rates of interest also change. A decrease in the supply of bank money through the sale of securities will have the effect of raising the market interest rates. Similarly, an increase in the supply of bank money through purchase of securities will reduce the market interest rates. Thus open market operations have a direct influence on the market rates of interest also.

3. Variable Reserve Ratio

Variable reserve ratio (or required reserve ratio or legal minimum requirements) as a method of credit control was first suggested by Keynes in his Treatise on Money(1930) and was adopted by the Federal Reserve System of the United States in 1935.

Every commercial bank is required by law to maintain a minimum percentage of its deposits with the central bank. It may be either a percentage of its time and demand deposits separately or of total deposits. Whenever the amount of money remains with the commercial banks over and above these minimum reserves is known as the 'excess reserves.' It is on the basis of these excess reserves that the commercial bank is able to create credit. The larger the size of excess reserves, the greater is the power of a bank to create credit. and vice versa.

Changes in cash reserve ratio is a powerful method for influencing not only the volume of excess reserves with the commercial banks but also the credit multiplier of the banking system. A change in reserve requirements affect the money supply in two ways: (a) it changes the level of excess reserves; and (b) it changes the credit multiplier

Suppose the commercial bank keep 10% of their central bank. This means Rs.10 of reserves would be required to support Rs.100 of deposit and the credit multiplier is 10 (ie. 1/10% = 10). To check inflation, the central bank raises the cash reserve ratio from 10% to 12%. As a result, the commercial banks will have to maintain a greater cash reserve of Rs.12 instead of Rs.10 for every deposit of Rs.100 and they will now decrease their lending by 2%. The credit multiplier will fall from 10 to 8.3 (ie. 1/12% = 8.3). On the other hand, to check deflation, the central bank may reduce the cash reserve ratio from 10% to 8% and thus make available 2% excess reserve to commercial banks which they utilize to expand credit. The credit multiplier will then rise from 10 to 12.5 (ie. 1/8% = 12.5).

4. Selective Credit Controls

Selective or qualitative methods of credit control are meant to regulate and control the supply of credit among its possible users and uses. They are different from quantitative or general methods which aim at controlling the cost and quantity of credit. The aim of selective credit control is to channelize the flow of bank credit from speculative and other undesirable purposes to socially desirable and economically useful uses. They also restrict the demand for money by lying down certain conditions for borrowers. The main types of selective credit controls generally used by the central banks in different countries are cited below:

a) Regulation of Margin Requirements

This method is employed to prevent excessive use of credit to purchase or carry securities by speculators. The central bank fixes minimum margin requirements on loans for purchasing or carrying securities. Control over margin requirements means control over down payments that must be made in buying securities on credit. The margin requirement is the difference between the market value of the security and its maximum loan value.

If a security has a market value of Rs.100 and if the marginal requirement is 60% the maximum loan that can be advanced for the purchase of security Rs.40. Similarly, a marginal requirement of 80% would allow borrowing of only 20% of the price of the security and a marginal requirement of 100% means that the purchasers of securities must pay the whole price in cash. Thus an increase in marginal requirements will reduce the amount that can be borrowed for the purchase of a security.

b) **Regulation of Consumer Credit**

Under the consumer credit system, a certain percentage of the price of the durable goods is paid by the consumer in cash. The balance is financed through the bank credit which is repayable by the consumer in installments. The central bank can control the consumer credit by (a)changing the amount that can be borrowed for the purchase of the consumer durables and (b)changing the maximum period over which the installments can be extended.

c) **Rationing of Credit**

Rationing of credit may assume two forms: (i) the central bank may fix its rediscounting facilities for any particular bank; (ii) the central bank may fix the minimum ratio regarding the capital of a commercial bank to its total assets. In other words, credit rationing aims at (1) limiting the maximum loans and advances to the commercial banks, and (2) fixing ceiling for specific categories of loans and advances.

d) **Moral Suasion**

Moral suasion means advising, requesting and persuading the commercial banks to cooperate with the central bank in implementing with its monetary policy. Through this method, the central bank merely uses its moral influence to make the commercial bank to follow its policies. For instance, the central bank may request the commercial banks not to grant loans for speculative purposes. Similarly, the central bank may persuade the commercial banks not to approach it for financial accommodation. This method is a psychological method and its effectiveness depends upon the immediate and favourable response from the commercial banks.

e) **Publicity**

The central banks also use publicity as a method of credit control. Through publicity, the central bank seeks : (i) to influence the credit policies of the commercial banks; (ii) to educate people regarding the economic and monetary condition of the country; and (iii) to influence the public opinion in favour of its monetary policy.

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- MATHEMATICS STUDY MATERIAL with Question Bank.
- ENGLISH STUDY MATERIAL with Question Bank.
- PHYSICS STUDY MATERIAL with Question Bank.
- CHEMISTRY STUDY MATERIAL with Question Bank.
- MODERN OFFICE PRACTICE STUDY MATERIAL with Q.B.
- COMPUTER SCIENCE STUDY MATERIAL with Question Bank.
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