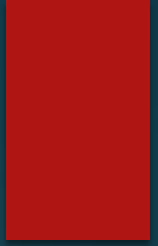
THE CENTRAL BANK



WHAT IS CENTRAL BANK?

- ❖It refers to an ‘Apex’(supreme) body that controls, regulates and direct the entire banking and monetary structure of the country

- ❖All financially developed countries have their own central bank.

- ❖Central Bank of India – Reserve Bank of India (RBI) (1st April 1935)

FUNCTIONS OF CENTRAL BANK

1) Currency Authority

5) Lender of last resort

2) Banker to the government

6) Clearing house

3) Banker's bank and supervisor

7) Custodian of foreign exchange reserve

4) Custodian of cash reserve

8) Controller of money supply and credit

Currency Authority (Bank of Issue)

- Central Bank has the sole authority for issuing currency in the country.
- In India, RBI has the sole right of issuing paper currency notes (except one –rupee notes and coins, which are issued by Ministry of Finance)
- Central bank keeps three main consideration regarding issue of notes-
  (1) Uniformity (2) Elasticity (3) Safety
- Central bank is obliged to back the currency with assets(gold coins, foreign securities, domestic government's local currency securities) of equal value , to enhance the public confidence in paper currency.
- RBI tries to keep money growth within a target range and keeps inflationary pressure at a low level.

Government is also authorized to borrow money from Central bank.

When government faces deficit in its budget, it borrows from central bank by selling its securities.

When central bank acquires these securities they issue new currency.

This is known as ‘**Monetizing the government debt**’ or ‘**Deficit financing**’

Banker to the Government

The Reserve bank of India acts **as a banker, agent and a financial advisor** to the Central government and all the state government(except that of Jammu and Kashmir)

As a banker, it carries out the following functions :-

- It maintains a current account for keeping their cash balances
- It accepts receipts and payments for the government and carries out exchange, and other banking operations.
- It also gives loans and advances to the government for temporary periods

As an agent, the central bank also has the responsibility of managing the public debt

As a financial advisor, the central bank advises the government from time to time on economic, financial and monetary matters

Banker's Bank and Supervisor

The central bank acts as the banker to other banks in the same way as commercial banks acts for general public.
As the banker's bank it performs the following functions:-

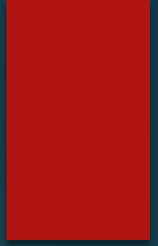
1) It accepts deposits and advances loans to commercial banks
2) It also provides 'clearing house' facility to the commercial banks. It is a cheque clearing facility provided at one centre to all the banks.
3) In its supervisory role, central bank regulates and controls commercial banks. The regulation of banks may be related to branch expansion, their licensing etc. The control is exercised by periodic inspection of banks and the returns filed by them .

Custodian of Cash Reserves

Commercial banks are required to keep a certain proportion of their deposits (known as Cash Reserve Ratio or CRR) with the central bank. In this way, central bank acts as a custodian of cash reserves of commercial banks.

Lender of last resort

When commercial banks fail to meet their financial requirements from other sources, they approach the central bank to give loans and advances as lender of the last resort. Central bank assists these banks through discounting of approves securities and bills of exchange.



Clearing house

As central bank holds the cash reserves of all the commercial banks, it becomes easier and more convenient for it to act as their clearing house. All commercial banks have their accounts with the central bank. Therefore , the central bank can easily settle claims of various commercial banks against each other, by making debit and credit entries in their accounts.

Custodian of foreign exchange reserves

Central bank maintains foreign exchange reserve in order to promote international trade and also exercises 'managed floating' to stabilize exchange rate for the domestic country by selling and purchasing of foreign exchange.

Controller of Money Supply and Credit

The Reserve Bank of India is empowered to regulate the money supply in the economy through its ‘ Monetary Policy’. It is a policy adopted by the Central bank of an economy in the direction of credit control or money supply. As RBI has the sole monopoly in currency issue, it can control credit and supply of money.

CONTROL OF MONEY SUPPLY (OR CREDIT SUPPLY) BY THE CENTRAL BANK (RBI IN INDIA)

The central bank adopts various measures to control the supply of money in the economy. Largely, these measures relate to credit supply by the commercial banks.

To control the money supply or credit supply RBI uses two types of instruments.

QUANTITATIVE INSTRUMENTS

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QUANTITATIVE INSTRUMENTS OF CREDIT CONTROL

These instruments are used to influence the total volume of credit in an economy.

Central bank tries to increase or decrease the amount of credit available in an economy.

Supply of money is lowered to tackle inflation , and it is raised to tackle deflation.

Various quantitative instruments used by the central bank are as follow:-

BANK RATE (DISCOUNT RATE POLICY)

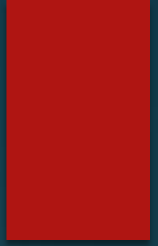
Bank rate is the rate at which the central bank of a country lends money to commercial banks to meet their long-term needs.

RBI has been actively using Bank rate to control credit. The bank rate is announced by the central bank at regular intervals in order to response to the market conditions.

An increase in bank rate increases the cost of borrowings from central bank.

It forces the commercial banks to increase their lending rates, which discourages the borrowers from taking loan.

And hence the ability of commercial banks to create credit decreases which helps in correcting the problem of inflation in an economy.

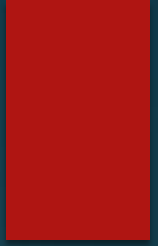


Rise in bank rate will lead to rise in market rate of interest which further increases the cost of capital and it leads to fall in demand for credit and fall in the supply of money which ultimately helps in correcting the problem of inflation.

On the other hand, when bank rate decreases , market rate of interest also decreases which leads to decrease in cost of capital and hence the demand for credit increases and the supply of money also which solves the problem of deflation .

OPEN MARKET OPERATIONS:-

It refers to the buying and selling of government securities by the central bank from/to the general public or commercial banks.



RBI is authorized to sell or purchase treasury bills and government securities.

Open market operations directly affects the supply of money in circulation and cash reserves held by the commercial banks.

Sale of securities by central bank to commercial banks reduces their cash reserve which adversely affects the bank ability to create credit and therefore decreases the money supply in the economy, whereas purchase of securities by central bank increases the reserves and credits creating power of commercial banks.

REPO RATE:-

Repo rate is the rate at which the central bank of a country lends money to commercial banks to meet their short-term needs.

The central bank advances loans against approved securities or eligible bills of exchange.

An increase in repo rate increases the cost of borrowings from the central bank. It forces the commercial banks to increase their lending rates, which discourages borrowers from taking loans. It reduces the ability of commercial banks to create credit. A decrease in the repo rate will have the opposite effect.

REVERSE REPO RATE:-

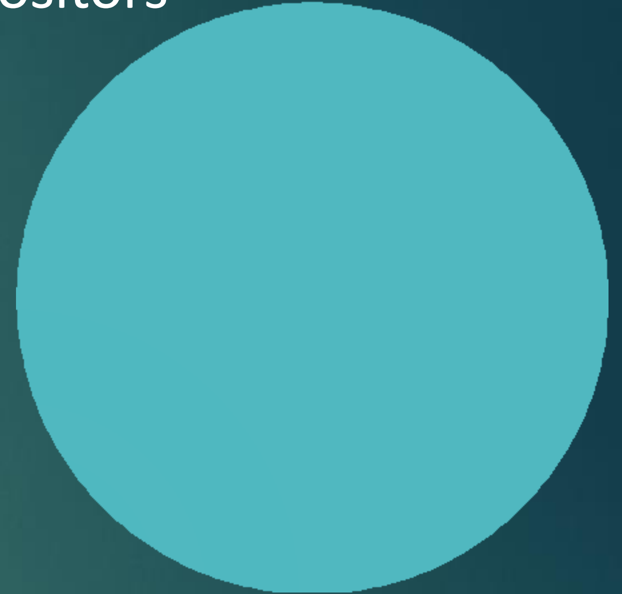
When the commercial banks have surplus funds, they can deposit the same with the Central bank and earn interest. The rate of interest paid by the Central bank on such deposits is called reverse repo rate. So, it is the rate of interest at which the Central bank accepts deposits from the commercial banks. Reverse repo rate allows the commercial banks to generate interest income.

When reverse repo rate is raised, it encourages the commercial banks to deposit their funds with the central bank. This has the negative effect on the lending capability of the commercial banks.

Lowering reverse repo rate has the opposite effect, which raises demand for borrowings from the commercial banks.

LEGAL RESERVE REQUIREMENT(LRR)

According to the policy of central bank, every commercial bank is obliged to maintain reserves out of the total deposits received from the depositors



It is a fast track method to control credit creating power of commercial banks.

Commercial banks are obliged to maintain 2 types of reserves

❖ **Cash Reserve Ratio (CRR)**

It refers to the minimum percentage of a bank's total deposits required to be kept with the RBI .

Change in CRR affects the ability of comercial banks to create credit.

i.e. Increase in CRR reduces the reserves of commercial banks and credit creating power of commercial banks and vice versa.`

❖ Statutory liquidity Ratio (SLR)

Every bank is required to maintain a fixed percentage of its assets in the form of liquid assets, called SLR.
The liquid assets include (i) cash, (ii) gold, (iii) unencumbered securities SLR is maintained in the form to show the liquid assets (power of banks to meet its daily requirements of cash withdrawl)
Increase in SLR reduces the ability of banks to give credit and vice versa.

QUALITATIVE INSTRUMENTS OF CREDIT CONTROL

These instruments are used to regulate the direction of credit.

Various instruments used by the central banks are:-

❖ MARGIN REQUIREMENT:-

It refers to the difference between market value of security offered for loan and the amount of loan given against that security.

Example- amount of building given as security for loan = ₹ 1,00,000
loan given against the security = ₹ 80,000
Margin = 20000 (1,00,000 – 80,000)

RBI may prescribe different margins for different sets of borrowers against the security of same commodity.

An increase in margin discourages the borrowers from taking loan and hence the money supply decreases, whereas a fall in margin encourages the people to borrow more.

❖ MORAL SUASSION

This is a combination of persuasion and pressure that central bank applies on other banks in order to get them act according to the policy of central bank.

It is like rendering an advice to the commercial banks by the RBI to follow its directives. The banks are advised to restrict loans during inflation, and be liberal in lending during deflation. Moral suasion can be used for both quantitative and qualitative credit control.

❖ RATIONING OF CREDIT (SELECTIVE CREDIT CONTROL)

Under this, RBI gives directions to other banks to give or not to give credit for certain purposes to particular sectors. This method can be applied in both positive and negative manner. In positive manner, it means using measures to channelize credit to priority sectors. The priority sector includes small scale industry, agriculture, exports, etc. In negative manner , it means using measures to restrict flow to credit to particular sectors