Central Banking: Functions and Credit Control

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Definition of Central Bank:--

Central banking has been defined by many economists on the basis of its functioning. Samulson defined 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." De Kock has defined the functions of Central Bank, they are :- (i) the regulation of the currency in accordance with the requirements of the economy, for this purpose they are given monopoly or almost monopoly for the issue of currency. (ii) The custody of the cash reserves of the commercial banks (iii) the custody and management of the nation's international currency (iv) the responsibility of lender of the last resort (v) settlement of clearances between the banks (vi) control of credit and laying out broad monetary policy.

Difference between Central bank and Commercial bank:-

1. Central bank (Reserve Bank of India or RBI) is an apex institution of the banking system of the country, commercial banks work under the guidance and control of central bank. Commercial banks are one of the many organs of the money market.
2. Central bank does not work with profit motive. Commercial banks are profit making institutions.
3. Central bank (RBI) is owned by the government while Commercial banks are owned by its shareholders that can be private owners or the state.
4. There is only one Central bank and can have many offices. The Commercial banks can be many in number with branches all over the country or abroad.
5. The chief executive of the Central bank is known as governor while the chief executive officer of Commercial banks is known as Chairman.
6. Central bank (RBI) is a banker to the government and does not have private account holder while the Commercial banks are banker to the public.
7. Central bank is banker's bank, the Commercial banks are banker to the public they accept deposits from and lend to the public.
8. Central bank issues currency and enjoys monopoly, the Commercial banks issue cheques.
9. Central bank controls credit. Commercial banks create credit.
10. Central bank is the custodian of the foreign currency. Commercial banks are dealers of foreign currency.

The central bank has many function to perform and they have almost same functions in all the countries. The central banks are controlled by the Government of the country but it has lot of autonomy and functions independently. The central bank controls the flow of money in any economy so it decides the monetary policy of the country in consonance with the Government, the formulator of fiscal policy, so that the two institutions contribute and complement each other in the economic development of the country.

The flow of money is very vital for the robust economy so monetary policy becomes very important. Central bank controls the flow of money in the country through its two main tools i.e. Issue of currency notes and credit control. The objectives of credit control are:-

1. **Stabilise the internal price level**. In order to prevent the shocks of inflation and deflation that adversely affect the economy the judicious credit control policy can be a very effective tool.
2. **Stabilise the rate of foreign Exchange**. The change of internal prices of commodities has its impact on the foreign trade of the country. If the prices in domestic market increase the exports fall and imports grow which makes the domestic currency weak vis-a-vis foreign currency this makes adverse impact on balance of payment of the country this leads to depletion in foreign exchange reserves. If the prices in internal market falls it leads to increase in exports and decrease in imports it makes the BoP favourable and rise in foreign currency reserves. This forces the central bank to export gold to other countries.
3. **Control Business cycles**. In capitalist economies the business cycles are common phenomenon i.e. periodic fluctuation in prices, production and employment these fluctuations are known as period of prosperity or boom and depression or recession. The Central bank can counter the business cycles through contraction of bank credit during the period of boom and expansion of bank credit during depression.
4. **Growth with stability**. The primary objective of credit control is to have growth with stability. The credit control policy can help in achieving full employment with price stability and control over foreign exchange rates with stability in the economy that is the ultimate aim of any country.

In, order to implement the monetary policy of the Central bank credit control is very effective tool. The two methods of credit control are **Qualitative and Quantitative**. The quantitative method is to control the quantity of credit money as well as the cost of credit, the qualitative method is used in controlling the direction and use of credit.

The instruments of **Quantitative** method of controlling the Credit are:-

1. **Bank rate Policy;-** Bank rate is the rate of interest at which Central bank lends to the Commercial banks or it rediscounts first class bills of exchange and government securities held by the Commercial banks through the discount window. The Central bank can very interest rates as per the need of the economy, if Central bank wants to increase the supply of the money in market and discourage saving it will lower the rate of interest or bank rate so that more and more people borrow money from the banks and make investment, this measure is taken when the economy is under the recession. In case of boom and high inflation in the economy Central bank increases the bank rate to discourage consumption and encourage saving so that the demand gets reduced and contraction

of credit brings inflation under control. At present the bank rate in India is 4.40% (Brought down from 5.15%) as declared on 27th March 2020.

Credit control through bank rate has got its own limitations. As we know that market rates of interest are not affected by the bank rate as they are determined by the market forces. We have seen that if there is period of boom the higher rate of interest does not deter the borrowers from taking the loans as the market sentiments are strong and there is upbeat in the economy so the higher bank rate does not discourage the borrowers. Mostly it is seen that wages, costs and prices are not elastic so the change in bank rate does not give the desired result, this is more evident in case of recession when the workers refuse to lower their wages, the economies where trade union is strong the lowering of wages becomes more difficult. Balance of payment is not always affected by the change of bank rate, as the foreign exchange rate is dependent on so many external factors which are beyond the control of internal economic adjustments. These are few reasons why most of the economists are of the view that bank rate is a weak weapon of monetary management.

2. **Open Market Operations: -** This is another quantitative method of Central bank to control credit. In open market operations Central bank sells and purchases securities, bills and bonds of government. By open market operations central bank influences the reserves of the Commercial banks and market interest rate to control the credit.

   The discussion that which method of credit control is better, bank rate or open market operation, or their effectiveness depends on the economic condition of the country. The experience of developed countries show that they complement each other and they are effective when both the instruments of credit control are used simultaneously. If the bank rate is raised to contract the credit it will not effective if the Commercial banks have large reserves, commercial banks will continue lending without changing the lending rate this will defeat the central bank's policy to decrease the money supply. But if the central bank takes away the excess money from the commercial banks by the sale of securities then raise the bank rate it will have the effect of contracting credit. If through open market operations the Central bank sells the securities and does not raise the bank rate it will not result in contracting the credit, as the commercial banks will get the funds from discount window (***The rate at which Central bank lends money to Commercial banks is known as repo rate this is very similar to Bank Rate it is 4.40% in India. Reverse repo rate is the rate at which Central bank borrows money from Commercial banks. As on 17th April2020 reverse repo rate 3.75%***) Central bank Commercial banks of the capital bank. To have effective credit control policy in tandem use of open market operations and bank rate is required.

3. **Variable reserve ratio:-** Keynes in his 'Treatise on Money' suggested variable reserve ratios, also known as legal minimum requirements, as an instrument of credit control. Every commercial bank is expected to maintain a minimum percentage of its deposits with the central bank, whatever money is left with the commercial bank over and above this legal reserve is known as excess reserves. The central bank can take away credit creation power of commercial banks by raising the required reserve ratios if the economy is in boom trade cycle and can reduce the reserve ratios when the

economy is passing from recession. In India the Central bank i.e. RBI has two variable reserve ratios, **CRR** (Cash Reserve Ratio) and **SLR** (Statutory Reserve Ratio).

Cash Reserve Ratio (CRR), is a requirement set by the Reserve Bank of India for Commercial banks to hold as reserves with the RBI in its current account. CRR is a certain percentage of total deposits of the Commercial banks that it has to hold as reserves with the central bank. This means that Commercial banks do not have access to that money so it can not lend that money to corporates or individual borrowers. Commercial banks do not get any interest on money held by RBI under CRR. The Reserve Bank of India decides this percentage and can change from time to time as per the economic requirements of the country, RBI has changed the **CRR and brought down to 3% on 17th April 2020**. After the RBI Act, 2006 there is no such base rate or ceiling rate for CRR. However prior to this Act the minimum limit was 3% and maximum limit was 20% of the total deposits.

Statutory Liquidity Ratio (SLR), in this variable ratio the RBI determines the percentage of total deposits which Commercial banks has to invest in certain specified securities, which are predominantly issued by central government and state governments. Reserve Bank of India fixes this limit, presently the limit is **18% of the total deposits**. The commercial banks keep these deposits with themselves and get interest on it. This instrument is used by the Central bank to regulate credits in the economy , by varying the limits of the SLR the money available with the Commercial banks for loaning can be increased or contracted as the per the need of the economy.

Selective Credit Controls or the qualitative Credit Controls are used by the Central bank to regulate and control the supply of credit among its users and uses, this instrument is different from quantitative control as it does not control the cost and amount of credit. Through selective credit control Reserve Bank of India channelizes the flow of Commercial banks credit from speculative and other undesirable purposes to socially desirable and economically useful purposes. There are many methods used by RBI for selective credit control for example taking margin money before advancing loans to the customers, it can issue guidelines to the Commercial banks regarding the percentage of margin money required for different kinds of loans. Another method of selective credit control is that it can instruct commercial banks to vary rate of interest for consumer goods e.g. lower rate of interest for durable consumer goods. Central banks of all the countries have power to issue directions regarding loaning of commercial banks from time to time and can encourage or discourage certain types of loan from time to time without altering the bank rate or variable requirement ratios. The qualitative credit control is much useful if we don’t want to alter the amount of money supply and yet want to encourage certain types of consumption or discourage some kinds of investment in an economy.