UNIT 7 CENTRAL BANKING

Structure

7.0 OBJECTIVES

After reading this unit, you should be able to:

- define what a central bank is
- identify the main differences between a central bank and a commercial bank
- list the various functions performed by a central bank
- explain the effectiveness of various instruments of credit control used by a central bank.

7.1 INTRODUCTION

A central bank is the apex institution of a country's monetary and financial system. It plays a leading role in organising, running, supervising and regulating the activities of commercial banks and other financial institutions in the country. The design and conduct of monetary and credit policies are its special responsibilities. Hence, the central bank plays a very important role in the balanced development of a modem economy.

In this unit, you will study the meaning and functions of a central bank, the difference between a central bank and commercial banks, and various credit control measures used by a central bank and their effectiveness.

7.2 WHAT IS A CENTRAL BANK?

All developed and most of developing countries have a central bank. However, in most countries the central bank is a 20th century financial institution. The Bank of England, the oldest central bank in the world, was set up in 1694 as a joint stock company by-an Act of Parliament. The Federal Reserve Bank in USA was established in 1913. In India, the Reserve Bank of India was set up on April 1, 1935 under the Reserve Bank of India Act, 1934.

The central bank occupies a pivotal position in the monetary and banking structure of every country. It is the highest monetary institution and a leader of the financial system of the country. However, it is not easy to give any precise and accurate definition of central bank. The definition of a central bank is largely derived from its functions. As functions of central banks vary between countries and over time, so does the definition of a central bank.

Different economists have defined'central bank differently. In the opinion 'of W.A. Shah, ***'Central Bank is that bank which controls credit'*** whereas Hawtrey holds the view that ***'the central bank is the lender of the last resort'.*** In the statutes of the Bank for International Settlements, a central bank has been defined as ***'the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in the country.'*** According to Kisch and Elkin a ***central bank is 'that bank the essential duty of which is*** *maintenance of stability of monetary standard,'* R.P. Kent has defined it as an *'institution charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of the general public welfare.'*

It is evident from all these definitions that various economists have defined central banking by laying emphasis on its different functions like control of credit, lender of the last resort, note issue, regulation of currency and credit, and stability of the value of money in the interest of general public welfare. However, we **may conclude that central bank is that highest financial institution of a country whose main function is to regulate, coordinate, integrate and guide the monetary and banking structure so as to realise certain desired goals of national and public welfare.**

The banking system can work efficiently only if there is an institution at the top to direct and coordinate its activities. Failing this, the banking system would be nothing but a collection of unconnected units, each following an independent policy, often contradictory to each other. At present there is hardly any country in the world which has not set up a central bank of its own. The government seeks to influence the working and policies of the central bank directly by active participation in the formulation of broad policy framework within which the bank has to function. The government can also influence indirectly through appointment of directors, governor and other high officials of the bank.

Distinction between a Central Bank and Commercial Banks

It will, however, be useful to identify the area of activities of a central bank and to distinguish the functioning and objectives of a central bank from the commercial banks. Some of the points of difference are as follows:

1) Where the commercial banks mainly aim to earn maximum profit for its shareholders, the prime objective of a central bank is the economic interest of the nation and not profit maximisation. The central bank aims at controling the banking system and support economic policy of the government.

2) The central bank is generally an organ of the government. Its actions are, therefore, closely coordinated with those of the other departments of the government, particularly with the departments of finance, industry and foreign trade. However, unless nationalised, the commercial banks are joint stock banks which are privately owned and privately managed.

3) An important requisite of a real central bank is that it should not perform such banking transactions which are meant to be performed by commercial banks e.g., accepting deposits from general public and accommodating regular commercial customers with discounts and advances. Except under such circumstances when it becomes absolutely necessary to have direct dealing with the general public, the central bank, deals with the public only indirectly through the commercial banks and money market.

4) The central bank enjoys the monopoly power of issuing currency notes and regulating the working of the commercial banking system of the country. No such powers are vested in commercial banks; rather they operate under the supervision and within the policy framework of the central bank.

5) Generally there are a number of commercial banks, but only one central bank in a country, the USA being an exception where there is a group of 12 Federal Reserve Banks functioning as central banks.

Check Your Progress A

1) Indicate whether the following statements are True or False.
   i) A commercial bank is the apex banking institution.
   ii) Bank of England was set up in 1894.
   iii) Central bank is normally entrusted with the duty of regulating the volume of currency and credit in the country.
   iv) Prime objective of a central bank is profit maximisation.
   v) Central bank has the monopoly of note issue.

2) Fill in the blanks:
   i) Generally there are a number of .... banks, but only one .... bank in the country.

ii) ....bank aims to control banking system.
iii) The design and conduct of monetary and credit policies are special responsibilities of ....bank.

7.3 FUNCTIONS OF A CENTRAL BANK

There is no unanimity about the powers and range of functions of a central bank. These have undergone a change over time and have differed between countries. However, we can broadly classify the functions of a central bank into two broad categories:

1) Traditional Functions
2) Promotional Functions

7.3.1 Traditional Functions

According to De Kock, a central bank should essentially perform the following seven functions which are now considered to be the traditional functions of a central bank.

1) Monopoly of Note Issue: The most important function of a modern central bank is that it enjoys exclusive right to issue currency notes. This function is so important that until the beginning of 20th century the central bank was known as the bank of issue. In the early days of banking, even commercial banks had the right to issue notes. But later on this practice was done away, and the power of issuing currency notes is entrusted to the central bank for the following reasons:
   i) It brings about uniformity in note issue, which is so important for the development of trade and industry.
   ii) It ensures reasonable supply of money in the economy and avoids any possibility of over-issue by individual banks.
   iii) It tends to render its control over the unwarranted credit expansion by the commercial banks.
   iv) It ensures better elasticity in note issue. It is because there may be careless expansion of money supply by commercial banks. Even the government may be tempted to increase its revenue by over-issue of currency notes which may lead to inflation in the economy.

   Hence, for the sake of uniformity, safety and elasticity, it is necessary that central bank should enjoy the monopoly of note-issue.

2) Banker, Agent and Financial Adviser to the State: The central bank functions as the custodian of govemment funds. As a banker of the govemment, the central bank accepts deposits on behalf of the government, and maintains banking accounts of both the government departments and government enterprises. It advances short-term loans to the government in anticipation of collection of taxes or raising of loans from the public. It also makes extraordinary advances during depression, war or any other national emergencies. As an agent of the government, it conducts transactions on behalf of the government involving the purchases or sales of foreign currencies, management of national debt, and also sale and purchase of government securities in the open market. In the role of financial adviser, central bank gives much sought-after advice to the government on important matters relating to economic policy. The RBI, for instance, has been advising the government of India on various economic policy matters like the stability of prices, funding of national debt, amount of deficit financing, etc., during the last two decades.

3) Bankers' Bank: The central bank functions as a banker to commercial banks. All commercial banks are required to keep certain percentage of their cash reserves with the central bank, by custom or by law. In fact, such an arrangement is useful for the banking system for a variety of reasons. Firstly, it enables the central bank to provide additional funds to such member banks which are in temporary financial difficulty. Secondly, it forms the basis for highly liquid and more elastic credit structure. Thirdly, it helps central banks to have an effective control over the credit creation by commercial banks. Fourthly, it ensures high degree of public confidence in the banking system and accords prestige to the currency notes issued by the central bank. Lastly, it helps in optimum utilisation of funds during periods of seasonal strain and in financial crises or general emergencies.

4) **Custodian of Gold and** Foreign Currency Reserves: **Today,** most of the central banks all over the world function as the custodians of nation's gold and foreign exchange reserves. Even before World War II, the central banks were required to keep gold and foreign exchange reserves for issuing paper currency which used to be convertible in those days. This right of central bank enables it to exercise a reasonable control over key foreign currency, reserves which is very vital to maintain the country's international liquidity position at a safe margin. Besides, it also helps the central Rank to stabilise the external value of home currency against foreign currencies. The central bank may buy its home currency in the foreign exchange market when its value is declining, and vice verso. The possession of gold and foreign exchange reserves also gives tremendous strength to a country in international financial dealings as gold is an internationally accepted medium of payment.

5) **Controller of *Credit:*** Controlling the credit operations of commercial banks has become probably the most important function of central bank in modem times. This is due to the fact that credit has become even more important than money, though money is the basis of entire credit system. Underlining the significance of control of credit by the central bank, M.W. De Kock has stated *that it is through this function that all other functions of the central bank are united and made to serve a conimon purpose.* W.A. Shaw considers control of credit to be *the primary function of a central bank as expansion or contraction of credit result in inflationary or deflationary conditions in the economy.* These unwarranted fluctuations in the volume of credit create wide fluctuations in the purchasing power of money and thereby cause great social and economic upheavals. It is, thus, of great importance that there should be some authority to control and regulate the credit creation activity of cotnmercial banks.

6) Bank of Central Clearance, ***Settlements*** **and** Transfer: The clearing function is now-a-days regarded as a necessary function of a central bank. As the central bank keeps cash balances of all commercial banks, it is quite easy for member banks to adjust their claims against each other in the books of central bank. This function of clearance, settlements, transfer of mutual claims was first evolved by Bank of England in 1854 which in course of time became an accepted normal function of a central bank all over the world. Since commercial banks keep their surplus funds as deposits with the central bank, it is far easier lo effect clearance and settlement of claims between them by making transfer entries in their books of accounts maintained with the central bank. If each bank were to enter into separate clearance and settlement transaction with other banks individually, it becomes difficult and laborious. Moreover, such an arrangement economises the use of money and the convenience that is experienced in the individual system of clearance and settlement.

7) **Lender of** the East Resort: Being the apex bank of the economy, central bank has to function as the lender of the last resort. This implies that the central bank assumes the responsibility of meeting directly or indirectly all reasonable demands of commercial banks for funds in times of difficulty anti financial crisis. The importance of central bank's function as the lender of the last resort was stressed by Walter Bagehot in **1873** in his book 'Lombard Street' wherein he drew the attention of the Bank of England to accommodate any eligible borrower in times of crisis. In the absence of this facility, the commercial banks will have to carry substantial cash reserves with them to meet such emergencies.

7.3.2 Promotional Functions

Apart from the traditional functions discussed above, the central bank also performs a number of developmental and promotional functions. The scope-of central bank's functions has widened during the Post-Second World War era and specially in the less developed countries where fast economic development has acquired urgency and high priority. Hence, in a developing economy like ours, the central bank assumes the responsibility of maintaining economic stability and assisting growth process in the following manner:

1) It helps to create and develop specialised institutions of agricultural finance in the country. In India, the RBI has helped in the creation of cooperative societies and agricultural cooperative banks by subscribing to their share capital so that fanners get timely financial help at reasonable rates of interest.

2) In order to ensure adequate supply of funds to industries, the central banks of some of

the developing countries have actively participated in setting up specialised institutions of industrial finance. Besides, it has also ensured that the small and tiny industries and the exporters are able to secure sufficient credit facilities at a relatively low rates of interest.

3) In addition to supervision and regulation of banking institutions, the central banks in developing countries have undertaken the responsibility of expansion of banking facilities, specially in rural and semi-urban areas which is so vital for balanced regional growth of the economy.

4) Promotion of well-organised and well integrated institutions and agencies of money market and capital market has become an important function of central bank in a developing economy. Thus, the central bank tries to remove institutional gaps in the money market and capital market which hinder the process of economic growth.

5) Above dl, the central bank undertakes the function of collection, compilation and publication of statistical data relating to the banking and financial sectors of the economy to highlight trends in the money market and capital market. This helps the state to take suitable economic decisions to tackle specific situations like controlling prices of essential goods, Mack money, etc.

Check Your Progress B

1) What are the seven traditional functions of a central bank?

....

....

....

....

2) State whether the following statements are True or False.
   i) The power of issuing currency notes lies only with the central bank of the country.
   ii) Central bank is the department of government.
   iii) All functions of a central bank are united through the function of credit control.
   iv) Central bank also has the promotional role of expanding banking in rural and semi-urban areas.

7.4 ROLE OF A CENTRAL BANK AS A CONTROLLER OF MONEY SUPPLY AND CREDIT

Central bank of a country takes care of the money supply and bank credit in an economy. While doing so, it tries to ensure that the total supply of money and bank credit, at any point of time, is in the best interest of the economy. In planned economies central banks have to develop such monetary policies which coordinate well with the overall plan framework and targets. Emergence of the system of managed paper currency in present day economies puts added responsibility on central banks of using restraint while issuing additional currency. The role of central bank in managing money supply and credit in the economy assumes further importance when the economies suffer from strong inflationary tendencies. In fact, the central bank often tries to reconcile several competing goals. For example, for the smooth functioning of economic activities and their expansion, it is necessary that there is growth in money supply and credit. But at the same time such growth must not lead to inflationary tendencies in the economy. Further, the monetary policies followed by the, central bank are to be formulated in such a way that they help in accelerating economic growth without adversely affecting distributive justice.

For achieving its diverse goals, a central bank may use various instruments to control money supply and credit. You will know about them later in this unit.

7.5 CONTROL OF CREDIT

There are several measures which a central bank may adopt to control the volume of money supply and credit in the economy. Broadly, these methods can be divided into two categories:

1) The quantitative methods or general instruments of credit control.
2) The qualitative methods, also known as selective credit controls.

While the quantitative controls relate to control of volume and cost of bank credit in general without regard to the field of economic activity in which credit will be used, the selective controls (qualitative methods) aim at affecting both the volume and cost of credit as well as the purpose for which credit is being offered by commercial banks.

7.5.1 Quantitative Methods

Under this category, there are four distinctive methods: 1) bank rate policy, 2) open market operations, 3) variable legal cash reserve ratio, and 4) secondary reserve requirements.

Bank Rate Policy

Bank rate refers to the rate of interest at which central bank rediscounts the eligible securities of member banks when they approach the central bank for accommodation so as to augment their liquid funds. They need these funds to expand credit facilities to their clients, specially during busy season. That is why bank rate is also called as **rediscount rate.** The bank rate policy is based on the following assumptions:

1) The lending rates of commercial banks are closely related to the bank rate. The businessmen will borrow and invest less when banks increase their lending rates due to increase in bank rate.
2) The banks keep only the minimum cash reserves with them and, hence, they have to approach the central bank for their additional cash requirements as and when need arises.
3) The banks possess eligible securities in sufficient quantities.
4) Prices, employment, wages and production are all flexible such that they will expand or contract according to changes in borrowing and investments of industrial and business houses.

Working of the Bank Rate Policy: The central bank controls the volume of credit indirectly by causing appropriate changes in the bank rate and thereby influence the lending rates of interest of the commercial banks. When there is inflationary condition in the economy, it reflects a state of excessive credit creation. To control inflation, the central bank, therefore, raises the bank rate. Increase in bank rate results in an increase in the lending rates of commercial banks. A hike in cost of bank loans will dissuade borrowers to seek more loans which will put a check on excessive credit creation by commercial banks. On the other hand, businessmen may liquidate some of their stock of goods to repay their loans. This will augment supply of goods in the market and help to check the rising trend of prices. When confronted by a deflationary situation, the central bank reduces the bank rate and thereby make borrowing cheaper so as to stimulate investments. However, the bank rate policy has lost much of its importance in recent years. The bank rate policy may become less effective when:

1) Commercial banks may have enough cash reserves and hence there is no need for them to approach central bank for additional cash.
2) It is possible that bank can raise funds from other sources and do not feel the qecessity to approach central bank for accommodation.
3) Commercial banks may not have enough approved first class bills and securities to get them rediscounted by the central bank.
4) In less developed countries where a large unorganised sector exists, lending rates of interest may not rise with increase in bank rate.
5) When profitability of investments is very high due to inflationary conditions in the economy, a bank rate hike will increase only cost of borrowing and may not affect demand for funds for investments. For example, in India, there has been a continuous rise in demand for bank credit id spite of rise in rates of interest.

Bank rate policy is considered to be an indirect method to control credit and for its success it is 'necessary that either the assumptions, on which it is based hold good or it should be used along with some other tools of credit control like open market operations.

Open Market Operations

Open market operations imply direct and deliberate buying and selling of securities and bills in the money market by the central bank to control tbe volume of credit.

Working of the Open Market Operations: When there are inflationary conditions in the economy, the central bank sells securities in the open market. This reduces the cash reserves of banks directly to the extent that they buy these securities. Besides, this also reduces the amount of customers' deposits with commercial banks to the extent that these customers acquire the securities sold by the central bank. Hence the sale of securities in the open market by the central bank reduces the credit creating base of the commercial banks and thus lead to contraction of credit and reduction in supply of money in circulation. This helps in controlling the rising demand for goods and services, thereby controlling rising trend in their prices. Conversely, the central bank purchases securities to augment cash reserves of commercial banks to increase volume of credit to combat deflation.

This method of credit control is considered to be superior to bank rate policy as it affects credit-creating capacity of banks directly by reducing their cash resewes. However, even this method has certain limitations which make this tool, at times, less effective. They are:

1) Open market operations succeed only when there is a broad, strong and active securities market. However, in less developed countries like India, there may be lack of such a market which render this policy ineffective.
2) The sale of securities may no: adversely affect liquidity of commercial banks as they may replenish the reserves by rediscounting facilities offered by the central bank.
3) Open market operations may not prove to be effective in controlling deflation. It is because even when central bank pumps more money into circulation by purchase of securities in the open market, it cannot force borrowers to borrow and invest more during deflation because prices fall and investments result in losses.

In view of these limitations, this weapon is generally used as a supplement to the bank rate policy. Therefore, both these methods are termed as complementary to each other for effective control of credit.

Variable Legal Cash Reserve Ratio

The variable cash reserve ratio is a comparatively new method of credit control by central banks. It was adopted for the first time by Federal Reserve System of USA. In countries where the money market is unorganised or underdeveloped, this method of credit control is resorted to most frequently.

At present every commercial bank is required, either by law or by custom, to keep a certain percentage of its total deposit liabilities with the central bank in the form of minimum legal cash reserves. 'Variation in this reserve ratio is likely to change the extent of liquidity with the commercial banks and consequently their lending powers. When credit contraction is desired, the central bank raises the cash reserve ratio, and when credit expansion is required it lowers the ratio. This method is more direct and has immediate effect on the volume of credit created by commercial banks. Cash creating capacity of the bank is calculated with the help of the following formula:

$$\Delta D = C \times \frac{1}{r}$$

where

ΔD = Change in total deposits
C = Cash deposits
r = Minimum cash reserve ratio

For examples, when cash reserve requirement is 10% and the banks have a total of Rs. 100 crore worth of cash deposits, their capacity to grant loans will be ten fold, i.e.,

$$\Delta D = 100 \times \frac{1}{10/100} = \text{Rs. } 1{,}000 \text{ crore.}$$

However, this credit creating capacity of banks will come down only to 5 times of Rs. 100 crore (i.e., Rs. 500 crore) if cash reserve ratio is increased to 20 per cent.

However, in spite of being a powerful tool to control credit, this method suffers from the following limitations:

1) It cannot be used very frequently as it creates a lot of uncertainty for the commercial banks.

2) It generates a depressing effect on the security market and thereby hampers the process of economic development by adversely affecting investment.

3) It is discriminatory in nature as it does not apply to non-banking financial intermediaries.

4) It may prove ineffective if the banks already have excess reserves.

5) A variation in minimum cash reserve ratio has to be only marginal as any large change in this ratio will create a lot of problems for commercial banks to make quick adjustments.

Secondary Reserve Requirements

The central banks are now empowered to fix for commercial banks not only a minimum cash reserve ratio but also a proportion of liquid assets to total assets. This further limits their capacity to create credit. The underlying idea is that commercial banks should not be given liberty to convert government securities and other liquid assets into business loans and advances. A higher secondary reserve requirement will mean less loans and advances for longer periods which prove inflationary. This weapon has been used by many countries including India to tight inflation by curbing the lending capacity of commercial banks. De Kock believes that this weapon can be made to play a valuable role in containing conditions of exceptional inflationary pressures. Normally, this method sf credit control is used along with variations in minimum cash reserve ratio so as to make it more effective.

The above discussion of general instruments of credit control bring out three facts. Firstly, no single method of credit control can prove to be really effective unless it is supplemented by some other method. Secondly, these methods may prove useful to control inflation but none of them is really a potent method to control deflation. Lastly, these methods fail to give favourable treatment to priority segments of the economy whose needs for bank credit are more urgent and socially desirable.

7.5.2 Qualitative Methods

Qualitative methods of credit control are also termed as selective instruments of credit control. Selective credit controls are considered to be superior to the general instruments of credit control as they are directed not only to control total volume of credit but also the specific uses for which credit is granted. In fact, selective controls draw a distinction between desirable and essential uses and undesirable and non-essential uses for which credit is granted. Its object is to diversify the flow of credit from undesirable uses to more important, desirable and productive uses. Selective controls include the following measures:

1) Variation in Margin Requirements: The practice of margin requirement is adopted by banks to determine the loan value of a collateral security offered by the borrowers. The loan value of the security equals the market value of security minus the margin. For example, the loan value of an equity share having market value of Rs. 125, at 20 per cent margin requirement is Rs. 125 – Rs. 25 = Rs. 100. Hence bank cannot offer loan more than Rs. 100 against this security.

   The cental bank is empowered to fix the margin for various types of collateral securities and thus influence the maximum limit of the loan. An increase in margin requirement will reduce the amount of loan which can be granted against a security. This will limit the quantum of credit and help combat inflation. Variation in margin requirement is a very effective device to regulate credit in speculative spheres without, at the same time, limiting availability of credit in other productive and socially desirable fields. Besides, this method is easy to administer effectively if the central bank can enlist the cooperation of commercial banks.

2) Regulation of Consumer Credit: This method of credit control was first used in America during World War 11 to restrict consumer demand for goods which were in short supply. Regulation of consumer credit has significance in those societies where there exists a system of large scale consumer credit through instalment—payments and hire-purchase. This method implies fixation of minimum amount of down-payment and the number of instalments in which loan is repayable. The central bank regulates consumer credit by fixing a maximum limit for the loan which can be granted by commercial banks to consumers of listed durable goods. For restraining consumer, credit during inflation, the central bank instructs to increase the amount of down payment and decrease the number of instalments to restrict demand for goods and

thereby control prices. However, in less developed nations where system of hire-purchase is not yet so popular, it has only limited scope in monetary management of the economy.

3) Rationing of Credit: This method plays a very significant role in diverting financial resources into the channels fixed by the planning authorities. Rationing of credit is a method by which the central bank seeks to fix ceiling of loans and advances and also in certain cases, fix limit for specific categories of loans and advances. In this way it tries to restrict credit in the non-priority segments so as to divert availability of credit in the desired sectors of the economy. This method, however, is often not liked by member banks as it tries to curtail the freedom and initiative of commercial banks.

4) Issue of Directives: In recent years central banks have started issuing directives to commercial banks to seek their help and cooperation in effective implementation of its monetary policy. Directives may be in the form of oral or written statements, appeals and warnings, particularly to curb individual credit structures and restrain total volume of loans. The success of directives depends on the extent of willingness of banks to cooperate with the central bank. Though flouting of directives is not punishable, yet commercial banks cooperate with central bank as the former depends heavily on the later for its smooth functioning. Directives are usually supplemented by some other tools of credit control.

5) Moral Suasion: It implies persuasion and request made by the central bank to commercial banks to follow the general monetary policy of the country. In a period of inflationary pressures, commercial banks may be persuaded to curb loan facilities for financing speculative and non-essential activities. During deflationary periods banks may be requested to expand their loans and advances even against inferior securities which they normally do not accept, This method involves only putting moral pressure on commercial banks to seek their cooperation as it does not carry any threat or legal sanction. However, in India moral suasion has been used successfully and effectively by the RBI. The Bank of England has also used this method with a fair degree of success in UK.

6) Direct Action: It refers to the penal action which a central bank may take against emng bank in any of the following forms:

   i) Central bank may charge penal rate of interest, over and above the bank rate, for credit demanded by a commercial bank beyond a prescribed limit.
   i) The central bank may refuse rediscounting facilities to those commercial banks whose credit policy is not in line with its general monetary policy.
   iii) The commercial banks whose borrowings are found to be in excess of their capital and cash reserves may be refused further credit facilities by the central bank.

   However, in practice it may not be easier for central bank to initiate action against any commercial bank as it is not always easy to ascertain non-essential and unproductive uses of credit. Besides, it is also difficult to ensure that a loan given for productive purposes has not been diverted to any speculative or non-essential use.

7) Publicity: The central banks in modem times try to bring psychological and moral pressures on banking system by giving publicity to unhealthy practices in the credit system and also what should be the right policy of the banks. The central bank regularly publishes statements of assets and liabilities of banking system, review of credit and business conditions and trends in the money market to help member banks to know what they ought to do.

Limitations of Selective Credit Controls

Selective credit controls also may not prove very effective to control credit and direct it to desired channels due to the following limitations in the credit system.

1) Success of selective controls is limited as these measures do not affect non-banking financial institutions.
2) It may not be possible to ensure that the loans advanced by the commercial banks are actually spent for the purposes for which they are granted.
3) In a limited way commercial banks guided by profit motive may grant loans for forbidden purposes and then make entries in their books of accounts under different headings to escape any penal action.

Hence we can conclude that success and effectiveness of monetary policy of central bank to a great extent depends on the degree of respect if command and the willingness of the commercial banks to extend full cooperation in the realisation of national economic objectives.

Check Your Progress C

1) Which of the following is a measure of selective credit control?
   i) Bank rate policy
   ii) Moral suasion
   iii) Statutory cash reserve ratio
   iv) Open market operations

2) When credit expansion is desired, a central bank should:
   i) Buy government securities in the open market
   ii) Raise bank rate
   iii) Fix higher margin requirements
   iv) Increase secondary liquidity ratio

3) Which of the following is not an objective of credit control:
   i) Economic growth
   ii) Economic welfare
   iii) Stability of prices
   iv) Stability of foreign exchange rate

4) Indicate whether the following statements are True or False.
   i) Moral suasion has generally proved to be very effective instrument of credit control.
   ii) Bank rate policy is the suitable measure to check inflation.
   iii) Increase in minimum cash reserve ratio will have immediate effect to curb expansion of credit and thereby help control inflation.
   iv) Open market operations are more effective than bank rate policy as the bank rate policy operates only 'indirectly'.
   v) In underdeveloped economies, it will be proper to rely on any one measure of credit control for effective monetary management.

5) Fill in the blanks:
   i) To expand consumer credit the banks will .... number of instalments for repayment of loans.
   ii) To check .... the central bank will resort to liberalisation of credit.

7.6 LET US SUM UP

The definition of a central bank is derived from the functions which it is supposed to perform. A central bank is an apex institution of a country's monetary and financial system which plays a leading role in organising, supervising, regulating and guiding the activities of commercial banks and other financial institutions. The central bank is in close touch with the government for effective implementation of the country's economic policy and helps in realising rapid economic growth with stability of internal prices and foreign exchange rate to maintain the economy in good health.

The broad policy framework of the monetary management is devised by the government in consultation with the central bank which is to be implemented by the latter. Besides, the Governor and other high officials of the central bank are also appointed by the government.

The central bank may be distinguished from commercial banks in respect of their objectives and the area of functioning. The commercial banks act as a link between the public and the central bank and aim at profits whereas the central bank's prime objective is national economic welfare. Further, the central bank has the monopoly of note issue, apart from being the leader of the entire monetary system.

Traditionally, a central bank performs seven important functions. It acts as bank of note issue and the lender of the last resort. It functions not only as government's banker and adviser but also as a banker to all the commercial banks. Besides, it acts as custodian of nation's gold and foreign exchange reserves. Above all, it controls volume of credit in the economy. However, in recent years, the central banks of developing counties have taken upon themselves the responsibility of helping in the promotion of such sectors as agriculture, industry and foreign trade for rapid economic development.

The most challenging task of a central bank is to control volume of credit in the economy. The general instruments of credit control are employed to control volume of credit whereas qualitative methods (selective credit controls) are employed to influence the direction of credit, The central bank, depending upon the circumstances, uses bank rate policy and open market operations to check fluctuations in the level of prices but rnay resort to variation in minimum cash reserve ratio and secondary reserve ratio to realise quick and immediate effect in controlling prices.

Qualitative methods to control credit have gained popularity in recent years. 'Through variations in margin requirements, changing number of instalments for loan repayments, and rationing of credit, the central bank aims at diversifying credit in the desired channels. The directives issued by the central bank and moral suasion have proved very effective measures of credit control. Besides, the threat of use of direct action prohibits commercial banks to flout the directives of the central bank.

7.7 KEYWORDS

Monetary Policy: That part of economic policy which regulates the level of money in the economy so as to achieve some desired policy objectives like price stability, growth, equilibrium in balance of payments. rtc.

Securities: Income yielding papers traded on stock exchange or in a secondary market.

4.8 ANSWERS TO CHECK YOUR PROGRESS

A) 1) i) False ii) False iii) True iv) False v) True
   2) i) Commercial, central ii) central iii) central

B) 1) i) Monopoly of note issue, ii) Banker, agent and financial adviser to the state, iii) Bankers' bank, iv) Custodian of gold and foreign exchange reserves, v) Controller of credit, vi) Bank of central clearance, settlements and transfer, vii) Lender of last resort.
   2) i) True iij False iii) True iv) True

C) 1) ii)
   2) i)
   3) ii)
   4) i) True ii) False iii) True iv) True v) False
   5) i) increase ii) deflation

7.9 TERMINAL QUESTIONS

1) What is a central bank? What makes a central bank different from commercial banks?
2) Discuss the traditional as well as promotional functions of a central bank in a modern economy.
3) What do you mean by selective credit controls'? In what way they are superior to traditional instruments of credit control'?
4) Differentiate between quantitative and qualitative methods of credit control and discuss the effectiveness of quantitative methods to control quantum of credit in an economy.
5) Discuss the working of the bank rate policy and open market operations and show how the two techniques are complementary to each other.

Note : 'These questions will help you to understand the unit better. Try to write answers for thern. But do not submit your answers to the university for assessment. These are for your practice only: