Karnataka State Open University
Manasagangothri, Mysore - 570 006

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ಮಾನಸಗಂಗೋತ್ರಿ, ಮೈಸೂರು - ೫೭೦ ೦೦೬

COURSE:5 **M.A.(PREVIOUS)**

MONEY-BANKING AND FINANCIAL MARKETS

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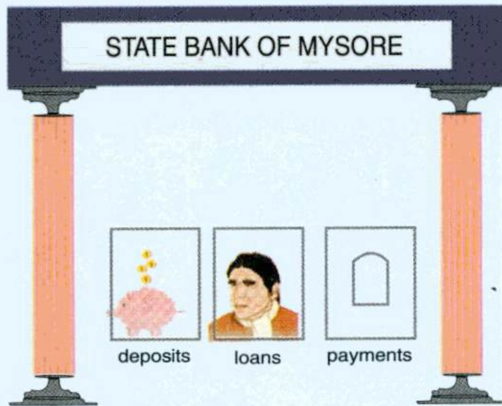

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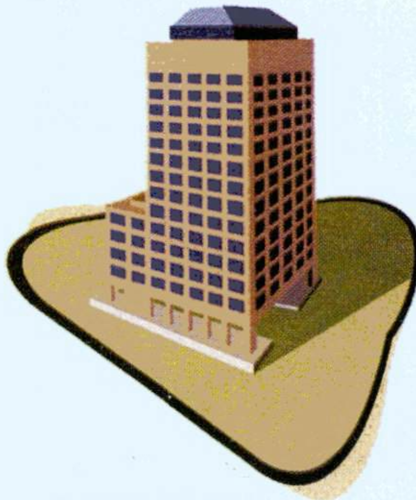

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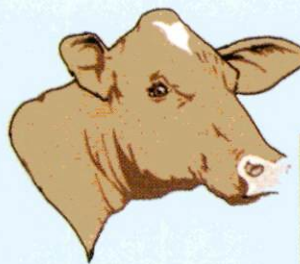

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Course 5
Block 4

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Karnataka State Open University

M.A. Economics (Previous)
Course-V
Money, Banking and Financial Markets

Block - IV

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Unit 12 to 17

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Block-4

Introduction

The present block 4 deals with the theoretical and operational aspects of central banking. Every economy has its own central bank, which performs vital functions for ensuring a stable and sustained growth of the economy. A central bank may be described as the institution in charge of controlling, a country's monetary system. It is the 'monetary authority' that formulates and implements the 'monetary policy' of the economy. The six units, of the present block is about the concept, functions and the role of central banks in economic development.

The structure of the block is as follows:

Unit 12: Concept of central Bank, Evolution and Role of Central Bank in Economic Development

Unit 13: Functions of Central Bank

Unit 14: Credit control: Bank Rate policy

Unit 15: Credit control: Open Market Operation

Unit 16: Variable Reserve Ratio

Unit 17: Selective Credit Control

UNIT 12

Central Banking : Concept, Evolution and its Role in Economic Development

Structure

12.1 Objectives

12.2 Introduction

12.3 Concept of Central Banking

12.4 Characteristics of a Central Bank

12.5 Evolution of Central Banks

12.5.1 Evolution of Bank of England

12.5.2 Present Position of Central Bank

12.6 Role of Central Bank in Economic Development

12.7 Let us sum up

12.8 Books for self study

12.9 Question for self study

12.1 Objectives

After going through the unit you should be able to :

i) Understand the meaning of central banking,
ii) Trace the evolution of central banking, and
iii) Appreciate the importance of central banking to an economy, especially its role economic development.

12.2 Introduction

The central bank occupies the apex position in a country's financial map. It is the leader of a country's money market. It regulates the flow of total money supply as well as the amount of money that goes to a particular sector / activity at any given point of time. It is, thus, responsible for safe-guarding the financial stability of the country and holds the reserves of the nation. It is, therefore, a symbol of financial sovereignty and stability of a country. Through its varied functions it also plays a very important role in economic development of a country. This unit is devoted to the study of the concept and evolution of central banking and discussing its role in economic development.

12.3 Concept of Central Banking

Central bank is an institution that can maximise economic welfare of a nation by regulating money supply and credit creation through its monetary policy. Different economists have defined a central bank in different ways.

R.K. Pint describes central bank as an institution that increases or decreases the money supply for achieving social welfare. Any bank which enjoys the exclusive right of money supply (currency issue) is central bank says Vera Smith. H.G.Harte is of the opinion that regulation of credit is the major function of a central bank.

According to M.H. Dekock, 'a central bank is the apex institution monetary and banking structure of its country and which performs as best as it can the following function :

i) regulation of currency in accordance with the requirements of business and general public, for which purpose it is granted either the sole right of note issue or at least a partial monopoly thereof;
ii) The performance of general banking and agency services for the state;
iii) The custodian of cash reserves of the common banks;
iv) The custody and management of the nation's reserves of international currency

v) The granting of accommodation in the form of rediscounts or collateral advances, to commercial banks bill, brokers and dealers, or other financial institutions, and the general acceptance of the responsibilities of lender of last resort;

vi) The settlement of clearance of balances between the banks; and

vii) The control of credit in accordance with the needs of business and with a view to carrying out the broad monetary policy of the state.'

Further a central bank is not expected to perform the general commercial banking functions.

Thus, a central bank may be described as an apex financial institution of the country, that possess the sole power of issue of currency, acts as a banker to the government and to other banks and controls the credit availability in the economy through a suitable monetary policy.

12.4 Characteristics of a Central bank

Economists have differed as far as assigning the main function that characterises a central bank.

According to Hawtrey the lender of the last resort is an essential characteristic of a central bank. Shaw is of the opinion ' the one true, but at the same time all-sufficing function of a central bank is control credit' Kisch and Elkin's are of the view that 'the essential feature of a central bank is its responsibility to maintain the stability of the monetary standard'.

Moreover since a number of central banks across the world are named as the reserve bank the custody of reserves is an important function that characterises the central bank.

However, whatever the individual opinions are a central bank is one, which performs all the usual central banking functions. The guiding principle for a central bank, whatever functions it performs at any time, is that it should act only in the public interest and without regard to profit as a primary consideration.

Therefore, a central bank is distinguished on the basis of certain distinct functions it performs which are also its salient features. In fact, the history of the evolution of its various functions themselves. hence, it can be said that due to the functions performed, a bank is called a central bank.

Check your progress

i) Explain the criteria to distinguish central bank from other banks.

ii) Do you feel the necessity of a separate central bank for a country? Justify

12.5 Evolution of Central Banks

Before the 20th century, there was no well defined concept of central banking. A gradual evolution took place in various countries for a long period of time, but according to Dekock, 'the process was not always a conscious, systematic and consistent one.

In many countries, initially, one bank gradually assumed more powers characterising a central bank viz., enjoying the sole right of note issue and acting as the banker and agent of the government. They were then called as 'banks of issue' or 'national banks'. The regulation of currency issue and maintaining the monetary standards were the main functions of these banks. As time advanced, these banks acquired other functions, duties and power until the term 'central bank came to be generally used and assumed a standardised meaning. In a sense, the gradual assumption of the usual central banking function by one of the banks and getting the recognition as a central bank is the account of its evolution. Although in the initial years, a stronger bank evolved so and was nationalised in due course, during recent years the national governments have statutorily established central bank specifying the functions they need to perform.

Of the existing central banks, the Riksbank of Sweden is the oldest bank as it was first established. But the Bank of England has been considered as the first bank and to develop what are now generally recognised as the fundamentals of the art of central banking. The history of the Bank of England is them universally accepted as illustrating the evolution of central banking principles and techniques (Dekock, 1961).

12.5.1 Evolution of Bank of England

The Bank of England was established in 1694 by public subscription for the purpose of advancing money to the government. This was in lieu of the privilege of note issue conferred on it by an Act of the Parliament. For some time, the Bank shared the responsibility of note issue with few other banking institutions. Thus, it was a partial monopoly of note issue. In 1883, however, only its notes were considered legal tender.

The other banks' power of issue was restricted to the amount that was in circulation and in some certain circumstances the power lapsed. Thus, the Bank of England enjoyed a gradual expression of its monopoly of note issue. Its assumption of the role of the banker and agent to the government later on placed the Bank of England in a special position vis-à-vis the other banks. Soon it was realised by the other banks that it is advantageous to keep an account with the Bank of England as its notes commanded the greatest confidence, were in widest circulation and it is the banker and agent of the government. Thus all the banks started keeping their excess cash/gold reserves with Bank of England. Thus the Bank come to be recognised as the custodian of the other banks' cash reserves as well as of the country's gold reserves. In 1954, the scheme of settling the differences between the various banks at the end of each clearing by transfers between their respective accounts at the bank also began. In this way, the Bank also became a bank of central clearance and settlements.

The next development was that the Bank come to accept the position of being the lender the last resort and to assume responsibility endeavoring to maintain not only the currency but also the credit system on a sound basis. The crises of 1847, 1857 and 1866 demonstrated how the position of the bank could be affected by speculation and undue expansion of credit. It was also realised that in certain circumstances financial panic could be created by the fear that the requisite banking facilities could not be obtained. But it was soon demonstrated that the bank can overcome such crises by meeting any type quantum of financial requirements, may be at temporarily higher rates with the purpose of accommodating the most urgent and essential needs and restricting the credit availability as a whole.

Thus, the regulatory function of the Bank came to receive a greater prominence and the use of bank rate as an instrument of credit policy came to be firmly established. Above all this, the successful appreciation of the paternal influence of the Bank in emergency situation gave the Bank of England great prestige and established it finally as the CENTRAL BANK OF GREAT BRITAIN. This evolution stimulated the development of central banking in other parts of the world.

The other banks which evolved and assumed the role of central banks were the Riksbank of Sweden, the Bank of France, the Bank of Netherlands, the National Bank of Austria, the Bank of Norway, the National Bank of Copenhagen (now Denmark), the National Bank of Belgium, the Bank of Spain, the Bank of Russia, the Rischsbank of Germany and the Bank of Japan. These banks and others in countries like Portugal, Romania, Bulgaria, Serbia, Turkey, Java, Egypt and Algeria came into existence during the 19th century itself.

In the early years of the twentieth century the remaining countries also established their own central banks. While in some countries, some of the existing strong and predominant banks, in other countries, the central banks were established by an act of legislations. For instance in India the Reserve Bank of India came in to being vide the Reserve Bank of India Act of 1935.

Because of the crucial functions performed by the central banks, all the countries invariably have their own central bank.

12.5.2 Present Position of Central Bank

At present there is no country in the world which has not set up a central bank of its own. This is due to the growing realisation of the advantageous of having a central bank irrespective of the stage of economic development. The centralised cash reserves, the control of currency and credit vested in a single bank which is under direct supervision by the state offers many advantages to an economy. According to Dekock "the central bank offers the best means of communication and co-operation between the banking system of one country and that of another".

Although some differences exist in the constitutional structure and the statutory powers of various central banks, the operational and working principles are almost uniform throughout the world. Further, depending upon the economic structure of a country and its level of development, the specific functions tend to vary. But despite all this now a common central banking theory has emerged and is practiced. According to Dekock, as distinct from commercial bank, the central banks have developed their own codes of rules and practices that can be described as the art of central banking, but in a changing world it is still in the process of evolution and subject to periodical readjustment. It is now also legitimate to speak of the 'science of central banking'.

Moreover in the new world economic order where the national economic boundaries are disappearing the role central bank has become still more important. The unhindered cross-border movement of funds and liberalised financial system, reiterate the supervisory and regulatory functions of the central bank. In a liberalised economic environment the regulatory bodies have to function effectively and thus the need for a strong central bank.

Check Your Progress

i) How far the evolution of Bank of England explains the evolution of central banks?

ii) Do you feel the importance of central banks has increased in the liberalised regime?

12.6 Role of Central Bank in Economic Development

As already stated being as apex monetary institution of the country, the central bank performs varied functions that are in the best interests of the economy. The predominant instrument through which a central bank protects and promotes the economic interests of a nation and there by promotes its economic development is the monetary policy.

In the developed countries, the central bank has played a proactive role in their economic development through maintaining price and exchange rate stability. An additional responsibility being carried out by the central bank is sustaining of development and growth rate already attached.

Compared to the developed countries in the developing countries the central banks have to strive harder in supplementing the government's role in bringing about higher levels of development. Especially new countries that emerged in the post-1940 period have used the central bank and its monetary policy for achieving the objective of economic development.

A central bank helps economic development of a country in the following ways :

1. Increased monetization in the economic transaction and development of bank activities in the economy.

2. Maintaining stability of price level for a smooth economic progress. This is done by the central bank by controlling the money supply and the credit creation by the banks. In fact, the monopoly of note issue is so used as to release so much accuracy that is just adequate for the needs of the economy. Similarly, the central bank controls the credit creation capacity of the commercial banks either the availability of total credit is influences or its flow to specific sectors and activities may be decided. This results in a stable and desired structure of growth of the economy.

3. In a resource poor country, for an efficient allocation of the available resources, the banking system has to be well-organised and should function efficiently. The central bank as a leader of the banking system provides all the inputs for a healthy development of the banking system and in turn, the economy.

4. The central bank plays a crucial role in orderly development and operation

of the country money and capital markets. As you know whole the short term and working capital requirements of the business are met by the money market, the long term capital needs are usually met by the capital market. The orderly functioning of the stock market, the stability of stock prices as well as interest rates, liquidity of the bills of exchange and other commercial papers and prevention of speculative money market activities become crucial. This not only provides the needed resources and definite ness to the business but also offers enough scope for effective credit control. This role performed very effectively by a central bank. It is needless to mention that it contributes significantly to economic development of the country.

5. The expansion of international trade is crucial for economic development of any country. By managing the foreign exchange reserves as well as maintaining the stability of exchange rates, a central bank helps a country to overcome its underdevelopment. Moreover the developing countries always face the foreign exchange constraint and also misallocation of it. The central bank receives the foreign exchange on behalf of the government and allocates it as per the policy priorities. In this way also the central bank perform its developmental role.

6. The financial infrastructure is generally not developed and hence adequate investible reason for long term requirements are forth coming. In order to overcome this, the central banks, world over, have established specialised financial institutions. These institutions cater to the needs of a specific business or specific needs of the general business. It is possible for these institution, therefore, to muster resources from various sources and direct them to sectors and uses where they are required the most. Thus, the RBI has established a number of institutions like the IDBI, SIDBI, EXIM BANK, IRFC, NABARD, etc. It goes without saying that these institutions have given a fillip to the overall development of the economy.

Thus other than it's usual central banking functions a central bank participates in the developing process of a country. Depending upon a nation's first stage of development, level of economic growth and the stage of development of the money and capital markets, the nature and extent involvement of the central bank may be decided. Moreover, the monetary policy of the central bank is always a component of the country's economic policy.

Thus, whether a country is developed or developing the central bank has a vital role to play in supplementing the state in maintaining and promoting the economic growth therein.

Check Your Progress

State the means through which the RBI can contribute to the development of Indian Economy.

12.7 : Let us Sum up

The present unit introduces to you the concept of central banking. The central bank is defined as the apex monetary institution of the country that perform some distinct functions such as note issue; acting as banker and agent of the bank; conserving domestic and foreign exchange reserves; and controlling the credit creation capacity of the commeracial banks. The central bank is characterised by the special functions it performs. The instantaneously, but has evolved over the years. In fact the evolution of the central bank is an enumeration of the evolution of the central banking function. This is very well depicted in the evolution of the Bank of England. In a way, Bank of England is the first Central Bank to be set up so in the whole world. And because of the vital functions it performs all the countries found it necessary to have a central bank. There is no country without a central bank in the world today. Moreover, because of the developmental functions of the central bank, it has become inevitable to an economy. Central bank has become a catalytic agent in the development of an economy as well as sustaining it.

12.8 Questions For Self Study

i) Describe the meaning of central bank.

ii) Give an account of the evolution of central bank.

iii) Evaluate the role of central bank in promoting and maintaining the economic development.

12.9 Books For Self Study

1. DeKock M.H, 1961 : Central Banking, Staples Press, London.

2. Sayers R.S. 1975 : Modern Banking, Macmillan, New Delhi.

3. Shekhar K.C, 1998 : Banking Theory and Practice, Vikas Publishing House Private Limited, New Delhi.

4. Srivastava, P.K., 1995 : Banking Theory and Practice, Himalaya Publishing House, Mumbai.

UNIT 13

Functions of Central Bank

Structure

13.1: Objectives

13.2: Introduction

13.3: Functions of Central Banks

- 13.3.1: Monopoly of Note Issue
- 13.3.2: Banker to the Government
- 13.3.3: Bankers' Bank and Supervision of Banks
- 13.3.4: Custodian of Foreign Exchange Reserves
- 13.3.5: Controller of Credit

13.4: Other Functions

13.5 Let us sum up

13.6 Question for self study

13.7 Books for self study

13.1 Objectives

After going through this unit, you should be able to:

(i) Identify the functions of a central bank;

(ii) Appreciate the supervisory, regulatory and promotional role of a central bank; and

(iii) Understand the need for a strong and autonomous central bank for an economy.

13.2 Introduction

As you have already studied in unit 12, central bank is a very important institution in an economy. It is the monetary authority that is responsible for creation and regulation of money supply and laying the foundation for a stable and sustained growth of the economy. It also regulates the interest rates and the availability of credit. In the present unit, you will be studying in detail these functions of a central bank.

13.3 Functions of Central Bank

As has been said earlier, a central bank is an institution charged primarily with controlling a country's monetary system. It is the monetary authority that is responsible for overseeing the monetary system and executing the monetary policy. Hence a central bank is charged with many important functions for the purpose of ensuring a stable and sustained growth in the economy. For instance, according to the Preamble to the Reserve Bank of India Act 1934, "the main function of the bank is to regulate the issue of notes and the keeping of reserves with a view to secure monetary stability in India and generally to operate the currency and credit system of the country to its advantage".

It is also worth mentioning that overtime, the functions of a central bank have evolved and become more widened. The central banks in all the countries play different roles as regulators, supervisors and promoters. Although the scope and content of the functions may vary a little bit across the countries, a broad similarity is noticeable. In what follows, you shall study the central banking functions in detail.

The functions of a central bank may be classified as:

(a) Traditional central banking functions which include (i) monopoly of

note issue, (ii) banker to the government, (iii) bankers' bank, (iv) custodian of foreign exchange reserves, and (vi) controller of credit

(b) Other functions:
(i) Promotional functions and
(ii) Supervisory functions

First, we will study the traditional functions and later we will discuss the promotional and supervisory functions of the central bank.

13.3.1: Monopoly of Note Issue

Issue of currency notes is the monopoly of the central bank. Currency notes being the money in circulation, if unregulated will lead to inflationary situation. In the early periods of banking development, each bank issued notes resulting in frequent troubles. There was often overissue of notes resulting in inflation and other economic and financial consequences. Therefore, the government divided to exercise strict control over issue of currency. Later, it was entrusted to central bank only. In modern days, the central bank is set up in a country primarily for issue of notes.

If the central bank is to carry out the responsibility of maintaining the stability of the national monetary unit, it should have power of control over the issue of the same. In other words, it should have the sole right of note issue and should also be the sole channel for the output and intake of legal tender money.

Such a monopoly not only gives uniformity and confers greater prestige to the monetary unit, but also gives the central bank the power to control the expansion of credit by the commercial banks.

The currency will be issued against the reserves held in the form of bullion, foreign exchange and government securities. Based on the proportion of reserves held in relation to the value of notes issued, the system, of note issue of currency are of five types. They are, (i) Fixed fiduciary system, (ii) Partial fiduciary system, (iii) Statutory maximum money supply system, (iv) Proportional fiduciary system, and (v) Minimum reserve system.

Let us briefly understand the features of the above systems of note issue.

(i) **Fixed Fiduciary System:** Under the system, the central bank can issue notes to extent of the gold reserves held by the bank and the issue can exceed the reserves only by a fixed extent. If the demand for currency increases, additional currency cannot be issued unless the gold reserves increase. The advantage of this system is that the government

cannot pressurize the bank to issue additional currency and in this way, the inflationary pressures will be kept in check. But the system robs of the elasticity of money supply to the needs of the economy, especially during the times of crisis. Due to these reasons, the Bank of England had to give up this system of note issue during mid nineteenth century.

(ii) **Partial Fiduciary System:** This system, adopted by the Bank of England in 1844, provides that up to a certain level of currency, reserve was not essential. Up to this level, the government securities only served as the reserves. Issue of currency over and above this level necessitated corresponding gold reserves. Though this system was relatively elastic, it could not completely do away with the inelasticity problem.

(iii) **Statutory Maximum Money Supply System:** Under this system, the legislature of the country decides by law, the maximum amount of currency that can be issued during a given period of time. There is no necessity of gold reserves for such money. Although this is a very convenient one, it does not adjust to the fast changing requirements of current money market requirements. Moreover, the limit may not be always and might lead to inflationary tendencies as well as economic insecurity. Because of this reason, not may countries have adopted this system of note issue

(iv) **Proportional Reserve System:** Under this system, the central bank need not maintain gold reserves to the full extent of notes issued. The gold reserves should be in a fixed proportion of the value of money issued and for the remaining, the government securities and commercial letters are used as securities. This was introduced by the American Federal Reserve System in 1914. Under it, of the total currency issued 20 per cent was covered by the gold reserves. This system gives the upward elasticity in the supply of money but it is very difficult to withdraw currency whenever there is decline in the gold reserves. Thus, it cannot work well in times of recession.

(v) **Minimum Reserve System:** This system provides that the central bank should maintain a minimum amount of reserves of gold, government securities and foreign exchange reserves. Any amount of currency can be issued based on this minimum reserve. This system gives a greater freedom to the central bank in expanding the supply of money. India has been following this system since 1956. However, this system might result in overissue of currency and consequent inflationary tendency.

These various systems have evolved and a specific system that suits the economic conditions, aspirations of the economy is adopted. In this way, by

deciding upon how much money should be in circulation, the central bank ensures, economic growth with as little disturbance as possible.

Check your Progress

(i) Present arguments in favour of monopoly of the central bank for note issue.

(ii) Which according to you is a good system of currency issue? Why?

13.3.2: Banker to the Government

The next most important function of the central bank is to act as the banker to the government. All the balances of the government are kept with the central bank for which usually no interest is paid. The central bank also provides a number of agency services to the government. Generally, it acts as the fiscal agent of the government and also as the advisor to the latter in matters of currency, exchange as well as finance. It carries out the governments' exchange, remittance and other banking operations including management of public debt. According to Dekock, "Central banks operate as banker to the state not because it may be more convenient and economical to the state, but also because of the intimate connection between public finance and monetary finance".

An important function of the central bank is to provide short term loans to the governments to meet the temporary mismatches between their receipts and payments. This is usually done by discounting the government treasury bills either directly or when presented by other banks.

This role of the central bank has initiated debate on the nature of its relationship with the government. While the monetary policy of the country has to be formulated with mutual consultation, the question is what degree of autonomy should be given to the central bank? The nineteenth century view that the central bank should be under total control of the government has given way to the feeling that for efficient operation of the central bank, it should be given sufficient autonomy. The great depression of 1930s necessitated this fact. However, now a days, it is believed, as well as practiced, that the state and the central bank should act hand in gloves for maintaining internal and external security in the process of economic growth.

13.3.3: Bankers' Bank

Central bank is statutorily, the apex bank of the country that guides, supervises and regulates all other banks in the economy. The central

bank acts as a bankers' bank in three capacities: (i) custodian of cash reserves of commercial banks, (ii) lender of the last resort, and (iii) bank of central clearance, settlement and transfers. Let us briefly look at each one of these:

(i) Custodian of Cash Reserves of Commercial Banks: The commercial banks of a country keep certain proportion of their deposits as cash reserves with their respective central bank. Originally, this was optional but later on, most countries, have made it a statutory obligation.

The practice has a number of advantages: firstly, since a fixed proportion of cash is deposited with the central bank of a country, the confidence of the people in the banking system will increase; secondly, it economizes the use of cash, that is, nation's cash can be more efficiently utilized when it is concentrated at one place rather than scattered in the vaults of commercial banks; thirdly, it gives the central bank enough control over the credit creation by other banks; and fourthly, it affords elasticity to the credit situation of the country.

(ii) Lender of the last resort: When the banks have exhausted their own resources and failed to supplement their funds from the usual outside sources. There will be a likelihood of a 'run' on the banks, the central bank is called upon to function as the lender of the last resort. The central bank performs this role by rediscounting bills. Dekock describes rediscounting as the conversion of commercial credit into additional central bank credit. Rediscounting is thus applied also to treasury bills and to short term collateral loans to banks and other financial institutions made by the central bank against bills or promissory notes and government securities.

Rediscounting facility enables commercial banks to carry on their day-to-day business on smaller cash reserves, since they can always rely upon the central banks in terms of crisis. It gives increased elasticity and liquidity to the assets of the commercial banks. However, rediscounting should not be abused. It should be resorted to only in times of emergency. The central bank in turn should be ready to help in times of distress and be less liberal in ordinary times.

(iii) Clearing and Settlement: The central clearing function is performed by all central banks. This flows from the position of the central bank as custodian of cash reserves of the commercial banks. Since banks keep cash reserves with the central bank, settlements between them can be easily effected by mean of debits and credits in the books of central banks. This method of settling accounts, apart from being convenient, is economical as as regards the use of cash. It strengthens the banking system by reducing withdrawals of cash in times of crises. Further, it enables the central bank to

be well informed about the state of liquidity being maintained by the commercial banks with regard to their assets. This helps the central bank in its function of controlling the credit expansion in the country.

13.3.4: Custodian of Foreign Exchange Reserves

Central bank acts as the custodian of valuable foreign exchange reserves of a country. The foreign exchange in different currency forms is used by the central bank to effect international payments. Foreign exchange acts as international liquidity and is equivalent to gold reserves. In a developing country context conservation and proper management exchange is very vital as they face foreign exchange constraint. Moreover, for making international payments, a centralised institution is very essential. A country gets all these advantages due to the central bank and the functions it performs. The foreign exchange constraint of the developing countries is efficiently managed by the central banks as the scarce foreign exchange reserves are conserved and suitably allocated as per the developmental priorities of the government. The exchange rate stabilisation is also achieved in the process.

13.3.5 Credit control

Regulation and control of bank advances is the most important function of the central bank. The nature and volume of bank advances have a critical bearing on the state of the economy. Whenever inadequate credit is forth coming, the central bank should step in to stimulate the same. Similarly, when too much credit is flowing into few or undesirable channels the central bank should regulate the same. Thus, assurance of adequate credit into desirable channel through the action of the central bank supports the programmes of the government in ensuring growth with stability and with least distortions. This is done through adoption of certain instruments – quantitative and qualitative. Whereas the quantitative measures affect the total credit availability in the economy, the qualitative ones regulate the flow of credit to desired channels of activity. In unit 14 you will learn about this function of the central bank in detail.

13.4: Other functions

The above functions are called as the traditional or conventional functions of the central bank. In accordance with changing role of government as well as the development status of economies, the central bank has been asked to assume some other responsibilities. These functions supplement the government efforts in promoting the country's economic development. These roles are, therefore, not generally conditioned by a country's economic requirements.

Mometary policy that supplements the overall economic policy of the government would help in smooth economic development of a country. Thus, a central bank is a friend, philosopher and guide to an government as well as to the economy at large.

13.5 Let us Sum Up

Central bank is a very important institution in an economy. It is charged with controlling a country's monentary system and other important functions for the purpose of ensuring a stable and sustained growth in the economy. The central bank in all the countries play different roles as regulator, supervisors and promoters. But the functions are concerned there is very little defferences. In developed countries their role is to maintaining price stability and exchange rate stability but in developing countries their role is to bring higher level of development. Therfor the broad function of a central bank can be classifide in to (1) monopoly of note issue (2) banker to the governament (3) bankers bank (4) coustodian of foreign exchange reserves (5) credit control and (6) its role in economic development.

13.6 Questions For Self Study

1. Discuss the functions of the central bank in brief.

2. What are the advantages of having a strong and autonomous central bank ?

3. Assess the complementary role of central bank in ensuring stable economic development.

13.7 Books For Self Study

1. DeKock M.H, 1961 : Central Banking, Staples Press, London.

2. GOI, 2003 : Economic Survey, Ministry of Finance, Government of India, New Delhi.

3. Sayers R.S. 1975 : Modern Banking, Macmillan, New Delhi.

4. Shekhar K.C, 1998 : Banking Theory and Practice, Vikas Publishing House Private Limited, New Delhi.

5. Srivastava, P.K., 1995 : Banking Theory and Practice, Himalaya Publishing House, Mumbai.

UNIT –14

Credit Control: Bank Rate Policy

Structure

14.1 Objectives

14.2 Introduction

14.3 Credit control

14.4 Methods of credit control

14.5 Difficulties of credit control

14.6 Quantitative credit control methods

- 14.6.1 Bank Rate Policy
- 14.6.2 Operation
- 14.6.3 Short-term and long-term rates
- 14.6.4 Limitation of Bank Rate Policy
- 14.6.5 Evaluation

14.7 Bank Rate Policy in India

14.8 Let Us Sum up

14.9 Question for self study

14.10 Book for self study

14.1: Objectives

After going through this unit you should be able to:

(a) appreciate the need for credit control

(b) understand the meaning and mechanism of bank rate policy, and

(c) evaluate the effectiveness of bank rate policy as a measure of credit control.

14.2: Introduction

In unit 13, you have studied that one of the essential functions of any central bank is to regulate the creation of credit and hence supply of money in the economy. For a stable growth, adequate quantity of money has to be pumped into the economy and similarly excess money needs to be withdrawn. This adjustment of the money supply is done on a regular basis through the monetary policy formulated by the central bank. Since monetary policy is supplementary to overall economic policy, the central bank aids in uninterrupted progress of the economic activities. The commercial banks and other financial institutions that lend to the business are engaged in creation credit and the central bank regulates this activity through some instruments. This unit introduces to you, the need for credit control, instruments of credit control and explains in detail the bank rate policy.

14.3: Credit Control

As already mentioned control of credit is one of the most important functions of the central bank because it is the manifestation of the monetary policy of the economy. While the value of currency issued is one component of the total money supply in the economy, the amount of credit created and deployed by the commercial banks is another component. While the currency issued is under direct supervision of the central bank, the credit creation by the commercial banks also needs to be regulated for the regulation of price trends.

The general objectives of credit control are: safeguarding gold reserves of the country against internal and external drain, to maintain stability of internal prices, to achieve stability of foreign exchange, to control fluctuations in employment and output, and there by to assist in economic growth. De kock states that the primary objective of credit control is to combine the objective of international exchange stability with that of promoting and maintaining high levels of employment and real income.

14.4: Methods of Credit Control

In order to achieve the objectives mentioned above, a central bank employs a number of instruments of credit control. They can be classified as general or quantitative and selective or qualitative credit control methods. While the quantitative methods alter the total quantity of credit available in an economy at any given point of time, the selective instruments regulate the flow of credit to desired sectors and activities. Both the instruments are supplementary to each other. The specific instruments of credit control may be shown as under:

A. **Quantitative Methods:** Manipulation of the bank rate, open market operations, and variable cash reserve ratio.

B. **Selective Credit Control Methods:** Altering margin money requirements, regulation of consumer credit, credit ratioing, issue of directives, moral suasion and direct action.

In the later sections and units you will be studying about these methods in detail.

14.5: Difficulties of Credit Control

Although controlling credit is a cherished objective of the central bank and it takes necessary steps towards that, the above mentioned methods may not always be expected to produce effective results. The practical difficulties in implementation of credit control are discussed below:

(a) Bank credit is not the only form of credit. There is commercial credit like book credit, bills of exchange and promissory notes, which represents the purchasing power as any other form of credit and central bank has very little control over these.

(b) The unorganised banking segment and the indigenous bankers are outside the purview of the formal banking system and, therefore, not under direct control of the central bank.

(c) The co-operation by the commercial banks, which is indispensable for successful control of credit may not be forthcoming and this may render credit control ineffective.

(d) The central bank can not control the end use of credit, which again reduces the effectiveness of credit control.
Moreover, as Dekock observes, the personal element is generally

difficult to contend with and since the action, reaction and interaction of human factors cannot be accurately determined or completely neutralised the credit control may not be that easy.

However, these are only few limitations to the effect of monetary policy of the central bank and not that, the bank fails to control the credit. Despite these difficulties a modern central bank always strives to maintain orderly monetary conditions in the economy as well as to stabiles the general business conditions.

In what follows we will discuss these instruments of credit control in a greater detail.

Check Your Progress

(i) Why credit creation should be regulated? Explain.

(ii) What practical difficulties central bank force in implementing its credit control policy?

14.6: Quantitative Credit Control Methods

As already described the objective of quantitative or general credit controls is to regulate the amount of bank advances, i.e., to make the banks to lend more or lend less. In the remaining part of this unit we will be concerned with the bank rate policy and its manipulation to regulate the flow of credit into the economy.

14.6.1: Bank Rate Policy

The bank rate is the rate at which the central bank discounts first class bills of exchange. Thus it is the rate of discount of the central bank. It is different from the market rate, which prevails among the other lending institutions. The bank rate acts as a floor rate based upon which the other market rates are determined. The bank rate is usually higher than the market rate. The Bank of England used it since the mid-nineteenth century itself. The alteration of the bank rate leads to change in money market rates in corresponding directions.

This relationship between the bank rate and the market rate endows the central bank the power to influence the credit creation by the commercial banks. In a perfectly developed money market, the two bear more or less constant relationship, that is to say the general interest rates move with the bank rate. However, in underdeveloped money markets this may not be the case.

14.6.2: Working of the Bank Rate Policy

According to the theory of bank rate policy, changes in bank rate of the central bank are followed by corresponding changes in the local money rates. If the bank rate is raised, other lending rates will also rise and vice versa. These changes directly affect the supply and demand for money. Borrowing becomes dearer hence it is reduced when bank rate goes up resulting in contraction of credit. Similarly when bank rate comes down borrowing is encouraged because it becomes cheaper leading to an expansion of credit.

Since the domestic borrowing rates increase, the foreign funds will be attracted resulting in an increase inflow of the same when the bank rate is increased. Similarly, when rates are lowered there will be out flow of funds. Obviously, the internal price-level falls with contraction of credit and rises with its expansion.

Business activity is stimulated when the rates of interest are lowered as more funds, domestic and foreign, are made available, but discouraged whenever the rates of interest are increased. An adverse balance of trade can be corrected through lowering of domestic costs and prices by contraction of credit, therefore, this stimulates exports and discourages imports.

Bank rate has been the legacy of the Bank of England, it operated the system effectively under gold standard till 1914. The principle underlying the theory of bank rate policy is that a change in the bank rate will be followed by corresponding change in the market rate. For instance, if there is inflationary tendency in the economy, the central bank raises the bank rate, increasing the cost of borrowing, there by discouraging borrowing by businessmen. Lesser borrowing has a dampening effect on production and trade resulting in unemployment. This further decreases the purchasing power of the people as well as the demand for goods and service. This leads to further reduction in productive assets and employment. All these pull down the prices. Thus, an increase in the bank rate reduces the amount of money in circulation, reduction in money incomes and prices and a general slowing down of the economy. Conversely, a decrease in the bank rate reduce the market rates, stimulates borrowing, raises money incomes as well as price and expands the business activities.

Check your progress

Examine how bank rate can counter inflationary tendency in an economy.

14.6.3: Short-term and long-term rates

There is a discussion in the economic literature as to whether changes in the rate of interest influence short-term or long-term investment. Hawtrey and Keynes are the two dominant thinkers involved in it.

Hawtrey holds that any change in the bank rate influences the willingness of the middlemen and wholesale dealers to hold stocks of finished and partly finished goods, because these stocks are financed through short-term loans. For instance, an increase in the bank rate will discourage the wholesale dealers and they will reduce stocks, which would reduce production. This leads to reduced employment as well as contraction of purchasing power, affecting the wholesalers. The general tendency of postponing purchases expecting a further fall in prices, on the part of buyers, contributes to a downward spiral. This spreads to capital goods industries, which have to contract their output. The opposite occurs when bank rate is lowered.

This view has been criticised mainly on the ground that it gives undue importance to changes in interest rates, which is only one of the aspects of total cost of holding stocks. According to Lord Keynes the demand for working capital is not is sensitive to changes in the sort-term rates. He argues that economic situation is affected through long-term rates of interest and the value of fixed capital goods. Since short-term and long-term interest rates are related variations in bank rates influence both the rates of interest.

According to Keynes whenever the short-term rates of interest increase, the long-term rates increase too. Changes in investment are the major determinants of the level of economic activities. The investment depends upon rate of interest and marginal efficiency of capital (MEC). Given the MEC, when the rate of interest increases investment is reduced causing unemployment. This further leads to a fall in the purchasing power and decline in demand for consumer as well as capital goods. This process ultimately culminates in economic crisis and depression. A decrease in interest rate consequent to a reduction in bank rate gives rise to a process quite opposite to the one mentioned above.

Thus, while Hawtrey confines to short-term rates and consequent impact on the economic fundamentals, Keynes focuses on the long-term rates to describe the same.

14.6.4: Limitations of Bank Rate Policy

For a successful working of the bank rates, some conditions have to be fulfilled. Firstly, all other rates should follow the bank rate so that credit expands or contracts as the case may be. Secondly, the economic structure of the country should be elastic so that changes in credit conditions should lead to corresponding changes in wages, rents, production, trade etc. How-

ever in a number of countries due to the absence of the above conditions, the bank rate has not been always successful. The increased use of bank overdrafts and increase self-financing of business has made the interest rate exercise a little influence on the borrowings of the business. The rapid technological change and fear of obsolescence compels the businessmen to recover their costs within three to four years, which again reduces the influence of interest rates on their decisions.

Moreover, the high tax incidence renders the effect of interest rates on investment ineffective. In fact Keynes views that "the difference in MEC of investment reduces the impact of interest tares in investment". Since an increase in the bank rate results in reduction in investment, employment and income, Sayers states that it is an inferior instrument of credit control. Above all these, it has been experience that the advanced inflationary tendency or depression can not be controlled using bank rate policy alone. The bank rate also can not channelise the credit flow into desired sectors and activities, as it cannot control flow of credit to undesirable activities.

Because of all these reasons, the importance of bank rate as an instrument of credit control has been significantly reduced.

14.6.5: Evaluation

Despite the above factors, the bank rate policy has not gone completely out of use. Its relative importance has gone down. It is still used as an instrument for correcting wrong trends and restoring equilibrium through its influence on the supply of and demand for money. It is now widely recognised that interest is only one of the elements of cost as the state of trade and price is affected by several other factors. However, bank rate is being used in conjunction with other methods as well as suitable fiscal policy. Nevertheless, it can not be denied that the bank rate policy has useful role to perform. In fact, there has been a recently revival of the method in many countries. The bank rate has been recast as minimum lending rate (MLR) by the Bank of England.

Check Your Progress

(i) Examine how bank rate affects short-term as well as long-term rates of interest.

(ii) Explain how effective is bank rate policy in controlling credit.

14.7: Bank Rate Policy in India

The Reserve Bank of India Act defines bank rate as the 'standard rate' at which the Reserve Bank is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase under the Act. But for all practical purposes, the bank rate is taken as the rate at which the RBI extends advances to the commercial banks. The RBI has sparingly used the tool. The rate was increased to 9 percent in 1974 and remained so till July 1981, when it was raised to 10 percent. It removed the same till 1991 and after a slight rise soon after that, it was not changed till 1997, when it was declined. Thereafter it has been reduced continuously and presently it is pegged at 6.25 percent (as on 10th January 2003). But because a large portion of the credit is deployed by the non-banking institutions, speculative dealings, the presence of inflationary situation, and a large part of credit being advanced to priority sectors, the bank rate has not been that effective in controlling credit in India.

Check your progress

State reasons for non-effectiveness of the bank rate policy in India.

14.8: Let Us Sum up

Credit creation is an essential function of commercial banks. But too much creation of credit and/or channeling of credit into undesirable sectors and activities is harmful for the economy. Too much credit may lead to inflationary tendency while non-availability of credit may discourage investment thereby leading to a sluggish economic performance. The central bank of country is entrusted with the responsibility of controlling the creation as well as flow of credit. The central bank performs this function for maintaining internal as well as external stability of the economy and promoting its growth.

Of the various methods of credit control, bank rate is one of the earliest measures used by the central banks to regulate the quantity of money lent by the commercial banks. Assuming a direct link between bank rate and other rates of interest, manipulation of the bank rate yields desirable results. However, with changes in the nature of borrowing by the business as well as resorting to self-financing by business, the significance of bank rate has declined. But now a days it is effectively used with other methods of credit control as a part of a proactive monetary policy.

14.9 Questions For self study

(i) Examine the importance of credit control in a growing economy.

(ii) Explain the operation of the bank rate policy.

(iii) Is bank rate losing its importance? Justify.

14.10 Books for self study

1. DeKock M.H, 1961 : Central Banking, Staples Press, London.

2. GOI, 2003 : Economic Survey, Ministry of Finance, Government of India, New Delhi.

3. Sayers R.S. 1975 : Modern Banking, Macmillan, New Delhi.

4. Shekhar K.C, 1998 : Banking Theory and Practice, Vikas Publishing House Private Limited, New Delhi.

5. Srivastava, P.K., 1995 : Banking Theory and Practice,Himalaya publishing House, Mumbai.

UNIT 15

Credit Control : Open Market Operations

Structure

15.1 Objectives

15.2 Introduction

15.3 Meaning of open market operations

15.4 Mechanism of open market operations

15.5 Limitations

15.6 Open market operations in India

15.7 Let us sum up

15.8 Questions for self study

15.9 Books for self study

15.1: Objectives

The objectives of the unit are to:

(i) Understand the meaning of open market operations,

(ii) Analyses the mechanism of open market operations, and

(iii) Evaluate the effectiveness of open market operations in regulating credit creation in an economy.

15.2: Introduction

Open market operations are another form of intervention by the central bank to regulate the supply of money, in general, and credit creation by commercial banks, in particular. Since in certain respects, bank rate is ineffective to achieve its objective, open market operations have assumed significance. In the present unit, we study the mechanism of open market operations and its suitability as an instrument of credit control.

15.3 Meaning and Evolution

The open market operations (OMO) came into existence after the First World War. The changes in the basic economic structure of the countries, and limitations of bank rate policy in controlling credit creation by the commercial banks necessitated another alternative instrument. After 1919 the increased use of government securities gave rise to emergence of OMO. Continuous increase in public debt and the need to reduce the cost of the same required that rate of interest be kept at low levels. Hence, OMO came into under use along with the bank rate policy.

OMO implies the purchase and sale by a central bank of any kind of paper in which it deals, like government securities or any other public securities or trade bill etc. In practice however, the OMO is meant purchase or sale of government securities at the initiative of the central bank, as deliberate credit policy. That is in most countries, these operations are confined to the purchase and sale of government securities.

OMO assumed importance mainly owing to the limitations of the bank rate policy. It has been found that the OMO are better suited to influence the market trends directly. In the case of the bank rate policy, the central bank has to wait for the market to react. Its efficiency depends on its indirect influence in the market trends through changes in money rates, whereas OMO have direct effect on the volume of money and credit as well as on

money and interest rates generally. Thus OMO are considered superior to the bank rate policy.

However for achieving effective results both bank rate and OMO are often used in conjunction. OMO are employed to prepare the ground for a change in the bank rate. They are also used for creating and maintaining cheap money conditions on ground of public policy or as a means of absorbing excess liquid cash, for raising the necessary funds to finance the developmental activities of the state and for avoiding disturbances in the money market. Therefore OMO have come to be adopted as a principal method of credit control.

15.4: Mechanism of OMO

OMO influence the market trends by varying the total amount of money in circulation as well as the power of the commercial banks to create more credit. Purchases or sales of securities in the open market will be followed by a decrease or increase, respectively, of the total money in circulation. The cash reserves of the commercial banks will correspondingly contract or expand.

Suppose the central bank sells the securities in the open market, it receives payments from the banks and the cash balances of the purchasing banks decline. This reduces the banks' ability to lend and thus, credit is contracted. Conversely, when the central bank purchases securities it pays in terms of cash and the cash balances of the commercial banks increase enabling them to expand credit. "Take care of the legal tender money and credit will take care of itself" is the maxim.

These operations may be combined with the bank rate policy. Excess liquidity of the money market may be absorbed carrying out the OMO. Now if the central bank increases the bank rate, the money rates will readily respond. This is due to the fact that the banks will find it possible to increase their loans only by approaching the central bank, as their excess cash reserves are depleted. This can be obtained from the central bank only at a price. Naturally, they will increase their lending rates.

Check Your Progress

Explain how open market operations regulate the credit flow.

15.5: Limitations of open market operations

The OMO will be effective only when certain conditions are satis-

fied. The various limitations of OMO are specified below:

(i) The theory is that when the central bank purchases securities, the cash reserves of the member banks will be increased and conversely, the cash reserves will be decreased when the central bank sells securities. This may not happen if the sale of securities is offset by inflow of gold or by return of notes from circulation and hoards. The purchase of securities on the other hand may be accompanied by an outflow of gold or withdrawal of notes for increased currency requirements or for hoarding. In both the cases, the cash reserves of the member banks may remain unaffected.

(ii) Since the volume of credit creation depends upon the prevailing economic and political circumstances and not merely with reference to the cash reserves of the banks, the banks may not expand or contact credit according to the cash reserves. This is because the percentage of cash to credit is not rigidly fixed and loan varies within quiet wide limits.

(iii) When the commercial bank's cash reserves increase, the demand for loans and advances should also increase and vice-versa. But this may not happen. Owing to economic or political uncertainty, even cheap rates of interest may not attract borrowers. Conversely when trade is good and prospects for profit bright, entrepreneurs would borrow more even at high rates of interest.

(iv) Finally, the circulation of bank credit should have a constant velocity. But the velocity of bank deposits is rarely constant. It increases in periods of rising business activity and decrease in periods of depression. Thus, a policy of contracting credit may be neutralized by increased velocity of circulation and voiceovers.

Dekock points out that, "Sometimes it is not only a case of unwillingness to borrow on the part of the entrepreneurs but also of unwillingness to lend on the part of banks and lenders" that affect the overall credit flow in the economy.

Thus, due to the above reasons, the OMO alone may not be as effective as expected.

Check Your Progress

Recollect the circumstances that make the open market operations ineffective in controlling credit.

15.6: Open Market Operations in India

OMO operations as defined by the RBI, refer "broadly to the purchase and sale by the central bank of variety of assets such as foreign exchange, gold, government securities and even company shares". In practice, however, they are confined to the purchase and sale of government securities.

RBI has been resorting to OMO since long. But until recently their operations were totally unrelated monetary control. Presently the RBI has sought to use OMO as an instrument of monetary control itself.

Through this instrument the RBI is able to withdraw liquidity or inject liquidity in the economy. The Liquidity Adjustment Facility (LAF) combined with OMO has now emerged as a major tool of liquidity management in the economy. The shift towards indirect instruments has provided the monetary authority with grater flexibility in the conduct of monetary policy (GOI, 2003).

15.7: Let us Sum up

Inspite of these limitations, OMO are widely used for credit control. Especially in countries like the USA and the UK that have strong and active market in short term and long term government securities. Since there is a fairly close relationship between the sale and purchase of securities by the central bank and contraction and expansion, respectively of bank credit, the OMO are used in all the countries. But in conclusion it may be stated that OMO have not assumed the role of a full-fledged instrument of credit control, especially in countries with undeveloped money and capital markets. In such countries the traditional instruments of bank rate policy and OMO are to be supplemented by other weapons of credit control which are suitable to the financial climate of each country.

Questions For Self Study

(i) Explain the meaning and mechanism of open market operations.

(ii) Bring out the limitations of open market operations.

Books For Self Study

1. DeKock M.H, 1961 : Central Banking, Staples Press, London.

2. GOI, 2003 : Economic Survey, Ministry of Finance, Government of India, New Delhi.

3. Sayers R.S. 1975 : Modern Banking, Macmillan, New Delhi.

4. Shekhar KC, 1998 : Banking Theory and Practice, Vikas Publishing House Private Limited, New Delhi.

5 Srivastava, P.K., 1995 : Banking Theory and Practice, Himalaya Publishing House, Mumbai.

Unit- 16

Credit Control: Variable Reserve Ratio

16.1: Objectives

16.2: Introduction

16.3: Meaning of Variable Reserve Ratio

16.4: Limitations of Variable Reserve Ratio

16.5: Variable Reserve Ratio in India

16.5.1: Cash Reserve Ratio

16.5.2: Statutory Liquidity Ratio

16.6: Let us Sum up

16.7 Questions For Self Study

16.8 Books For Self Study

16.1: Objectives

After going through this unit you should be able to:

(i) Understand the mechanism of variable cash reserve ratio,

(ii) Appreciate the role of variable reserve ratio in control of credit , and

(iii) Evaluate the effectiveness of variable reserve ratio in its purpose.

16.2: Introduction

The limited efficacy of the traditional weapons of credit control has induced the central banks to explore the possibility of adopting new methods of credit control. With the evolution of the money market, as the commercial banks other financial institutions have explored new sources of liquidity to lend has expanded. In order to exercise control over the credit creation capacity of the bank new methods have been devised by the central banks. Relatively a new method of quantitative credit control has been the use of variable reserve ratio. The central banks, world over, have been manipulating the minimum cash reserves to be kept by the commercial banks with them. In the present unit we should study the meaning, mechanism and working of variable reserve ratio.

16.3: Meaning

Commercial banks in all the countries are required, by legislation, to keep a specific proportion of their deposits as cash reserve with the central bank. This minimum percentage of deposits to be deposited with the central bank in the form of cash is the reserve ratio, which the central bank can vary to serve the purpose of credit control. Hence, it is called as the variable (cash) reserve ratio (VRR).

The method was first suggested by the Federal Reserve Board in 1916 and adopted in the United States in 1993. Later on the method has been needy adapted in counties throughout the world. Reserve requirements were originally enforced upon the commercial banks with the main objective of imparting liquidity to them. It would also give adequate reserves to the central bank to perform its role as the lender of the last resort. However, the modern conception is that reserve requirement of commercial banks serve primarily not as a means of preserving their liquidity but as a medium through which their credit creation could be regulated.

Thus, the central purpose of variable reserve ratio is to endow the

central bank with an additional weapon in order to prevent injurious credit expansion or contraction by varying the reserve that is to be maintained by the commercial banks with the central bank. As has been stated by the Governors of the Federal Reserve System, "It is far better to sterilize part of these superfluous reserves while they are still unused than to permit a credit structure erected upon them and then withdraw the foundation of the structure. This is to limit the potential expansion of credit rather than restrict the current availability of money".

The variable reserve ratio is more effective vis-a-vis the open market operations. Firstly, for the OMO to be effective a well-developed securities market is quite necessary, which is not so for the effectiveness of variable reserve ratio. The variable reserve ratio directly affects the credit creation capacity of the commercial banks. Secondly the central bank as well as the commercial banks might incur losses in respect of OMO, which does not happen in respect of variable reserve ratio.

However, the central banks have been employing the quantitative techniques on complementary basis and have been effective in regulating the credit creation.

16.4: Limitations of Variable Reserve Ratio (VRR)

Although the VRR has found increasing favour with many central banks, it is subject to the following limitations:

(i) The VRR affect differently the big and the small banks. Since VRR is proportionate it is regressive in nature for the small banks as far as their capacity to create credit is concerned. To overcome this incremental reserve ratio for additional deposits has been stipulated in some countries. This further dampens the deposit mobilization initiative by the large banks and their consequent credit creation capacity.

(ii) The method is complained of lacking flexibility. It is incapable of correcting small or localized situation of credit stringency or superfluity.

(iii) The increase in VRR is also alleged to cause a depressing effect on the security market. Because when central bank increases the VRR, the commercial banks may try to replenish their cash reserve by selling securities in the market.

(iv) The high VRR impairs the profit earning capacity of the commercial banks.

(v) The method confers wide powers upon the central bank, leading to certain psychological stress to the commercial banks as to the speculation about the VRR.

Check Your Progress

(i) What do you mean by variable reserve ratio?

(ii) Do you feel VRR a better method of credit control?

(iii) Think of the ways to overcome the limitations of VRR.

16.5: Variable Reserve Ratio in India

The Reserve Bank of India also uses the VRR to control credit in India. By changing the ratio of reserves that the commercial banks are required to keep in the form of cash against their deposits, the RBI seeks to influence the credit creation power of the commercial banks. Two kinds of reserves that are maintained by the commercial banks with the RBI are cash reserve ratio (CRR) and statutory liquidity ratio (SLR).

16.5.1: Cash Reserve Ratio (CRR)

CRR refers to that portion of total deposits of a commercial bank, which it has to keep in the form of cash reserves with the RBI. The RBI is empowered to vary this CRR between 3 and 15 percent of the total demand and time deposits. The CRR has been liberally used and since 1973, it began to rise and reached 15 per cent in July 1989. However, following the recommendations of Narasimham Committee. CRR has been gradually reduced and as on 31-3-2003, it stands at 5 per cent (GOI, 2003).

16.5.2: Statutory Liquidity Ratio (SLR)

SLR refer to that portion of total deposits of commercial bank which it has to keep with it self in the form of cash reserves. SLR supplements CRR and is so designed as to prevent commercial bank from offsetting the impact of CRR by liquidating their government security holdings. SLR too was raised to as high as 38.5 per cent but after the recommendations of Narasimham Committee, it is also being gradually reduced. It is in tune with the liberalization policy of the government as well as to bestow more funds at the disposal of the banks. The SLR as on 31-3-2003 was 25 per cent (GOI, 2003).

Thus the RBI has used the variable reserve ratio to control the credit creation by the commercial banks and as a component of an active monetary policy.

16.6: Let us Sum up

The quantitative credit control methods seek to regulate the absolute quantity of credit creation by the commercial banks. The limitations of bank rate policy and open market operations necessitated the evolution and employment of variable reserve ratio. Unlike the first two methods which require a close linkage between the bank rate and market rates as well as a developed securities market; the VRR directly regulates the ability of banks to create credit. Since the commercial banks are required to keep a portion of their deposits in cash with the central bank or with themselves, their credit creation capacity is affected to that extent immediately. VRR when used in conjunction with other two methods is found to be more effective. Almost all countries have favoured the VRR to influence the credit creation capacity of the commercial banks.

Questions for self study

(i) Explain the meaning and working variable reserve ratio.

(ii) Do you favour conjunctive use of bank rate policy, open market operations and variable reserve ratio? Give reasons.

Books for self study

1. DeKock M.H, 1961 : Central Banking, Staples Press, London.
2. GOI, 2003 : Economic Survey, Ministry of Finance, Government of India, New Delhi.
3. Sayers R.S. 1975 : Modern Banking, Macmillan, New Delhi.
4. Shekhar K.C, 1998 : Banking Theory and Practice, Vikas Publishing House Private Limited, New Delhi.
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Unit 17

Selective Credit Control

Structure

17.1: Objectives

17.2: Introduction

17.3: Meaning of Selective Credit Controls

17.4: Objectives of Selective Credit Controls

17.5: Type of Selective Credit Controls

17.5.1: Margin Money Requirement

17.5.2: Regulation of Consumer Credit

17.5.3: Rationing of Credit

17.5.4: Direct Action

17.5.5: Issue of Directives

17.5.6: Moral Suasion

17.6: Significance of Selective Credit Controls

17.7: Limitations of Selective Credit Controls

17.8: Selective credit controls in India

17.9: Let us sum up

17.10: Questions for self study

17.11: Books for self study

17.1: Objectives

After going throughout this unit you should be able to:

(i) Know the meaning and nature of selective credit control (SCC) instruments,

(ii) Understand the features and objectives of selective credit controls,

(iii) Identify the circumstances in which the specific selective credit controls mechanism are applicable, and

(iv) Analyse the effectiveness of selective credit control instruments.

17.2: Introduction

In the previous units you have studied the mechanisms that are in use to control the absolute supply of credit in the economy. Sometimes, while pursuing an expansionary or cheap monetary policy, it becomes essential to restrict credit flow to few sectors whose expansion or contraction may not be in the interest of general economic growth. They affect directly the total availability of credit. They affect the whole economy indiscriminately without distinguishing between essential and non-essential uses of credit. Therefore, although they restrict the inflationary trends, they may not be promoting desired patterns of credit use and hence, development. That is why these general or quatitative credit control instruments are usually supplemented by selective or qualitative credit controls.

As the name itself indicates, these instruments selectively promote or restrict the availability of credit to a particular group of users or sectors. They essentially discriminate or are selective towards the desired sectors of the economy.

In the present unit you will be studying the various selective credit control instruments at the disposal of a central bank and their mechanisms.

17.3: Meaning of Selective Credit Control

These credit control methods that discriminate between uses, users and purposes of credit. The limitations of the quantitative methods compelled the central banks to adopt the selective credit controls to supplement their efforts to control the credit supply. The special features of selective credit controls can, therefore, be stated as:

(i) They distinguish between essential and non-essential uses and users of credit,

(ii) Only non-essential users are brought under the scope of credit control, and
(iii) They affect not only the lenders but also the borrowers.

17.4: Objective of Selective Credit Control

Usually the selective credit control instruments are used with the following objectives:

(i) Restricting bank credit to non-essential users and regulating the credit creation by banks.
(ii) Discouraging excessive consumer demand for certain luxurious consumer durable emerging due to hire purchase or installment trading system.
(iii) Discouraging investment in socially undesirable sectors and unwanted lines of business.
(iv) Correction of adverse balance of payments by providing credit at cheaper rates if interest to exporting firms and charging higher rates of interest on importing firms. Differential rate of interest can also be levied for credit for purchase of different imported commodities.
(v) Regulation of the credit creation by the non-bank financial institutions is also an objective of selective credit control.
Thus, the selective credit controls seem to attack the problem at the root itself and attempts to regulate the credit creation by banks.

17.5: Types of Selective Credit Controls

There are different forms of selective credit controls. Depending upon a country's monetary and banking development as well as growth requirements different instruments have been in use. We shall discuss these measures and their relative advantages and benefits hereunder:

17.5.1: Margin Money Requirements

The amount of lending by the commercial banks against securities will not be equal to the face value of the securities that may be offered. It will be some proportion of the value of the securities. That proportion of the value of the security, which is not lent, is the margin that the banks retain as a cushion against fluctuations in the prices of the securities. For e.g. if the margin money requirement is 20 per cent, if for security worth Rs.1000/- the bank can lend only Rs. 800/- retaining Rs.200/- as margin money. The central bank can vary this margin money and regulate the amount of money that can be lent to specific purposes. For instance in India, while the margin money required for loans for consumption are usually fixed at a higher level, for productive purposes very low margin requirement is stipulated. In fact for

priority sector lending no margin money is required. Similarly, during inflation, the central bank raises the margin requirements and reduces it during recessionary periods.

Margin money also implies the contribution that the borrower is required to make while borrowing for certain purposes. If the borrower is purchasing a durable commodity out of the loan, the bank usually insists on a specified proportion of the total value of the commodity as his/her contribution. Higher the requirement, discouraged is the borrower and vice-versa. For e.g. the margin required for housing loan in India has been fixed at 15 percent and varies from bank to bank as well as on the basis of the amount of loan.

- The implications of margin requirements are as follows:

(i) The Margin requirements regulate the speculative tendencies by diverting investible funds to productive lines.
(ii) High margin curtails the credit creation which regulating price rise and on the other hand, lower margins encourage credit creation and consequent expansion of the economy.
(iii) A high margin discourages speculative and hoarding activities by traders and middlemen.

In the USA it has also been noticed that margin requirements are helpful in regulation of stock prices. Margin requirements, therefore, are used in all the countries. In India they are being used since 1956.

17.5.2: Regulation of Consumer's Credit

The commercial banks have been giving credit for purchase of consumer durable goods and luxurious items. This type of credit is called as the consumer credit. Since the demand for consumer goods is extremely variable, it has a greater influence on general price level and consequent output and employment. Hence it is essential to regulate such type of credit in order to control cyclical fluctuations. The increased popularity of hire-purchase scheme and installment buying of consumer durable goods on the part of the borrowers and ease of lending as well as recovery on the part of the banks have made this method more important.

Regulation of consumer credit involves four important stages, viz.;

(i) The consumer goods falling within the purview of regulation should be defined and during inflation more number of commodities should be included for regulations. The banks should be directed not to

grant liberal credit to such items. During recessionary trends, opposite steps need to be initiated.

(ii) When the commodity is being purchased on installment basis the down payment can be varied. For instance if the down payment is lower, greater number of people will be willing to avail loan, but if it is higher, it will discourage borrowers. Thus, during inflation the down payment may be fixed at a higher level and during depression at a lower level.

(iii) Similarly, the number of installments and repayment period also needs to be determined. If the number of installments were low and repayment period short, not many would borrow. This is suitable during inflationary periods. Alternatively during recession, the number of installments is more and repayment period is long, borrowing would be encouraged to give a fillip to production and trade.

(iv) Lastly, the rate of interest manipulation is another instrument to regulate consumer credit. The exemption cost can also be varied.

These methods of credit control were extensively used in the U.S. in the later and post Second World War years. Almost all central banks, including India, have used consumer credit regulation effectively on a number of occasions.

17.5.3: Rationing of Credit

Credit rationing is employed by the central banks "as a temporary expedient or an abnormal measure dictated by special circumstances or as a part of a comprehensive scheme of national economic planning"

The central bank during times of monetary stringency, rationing of credit by limiting the amount of available to each applicant and restricting rediscounts to short term bills. Although the centrally planned economies used it extensively, the other countries have also used it during exceptionally difficult and critical conditions. Accounting to Wageman, ".... in more primitive economic nations, the setting of credit quotas is the only direct method which the central bank has in order to prevent excessive credit demands on the part of business". The method was used during different time provides by the Bank of England, Risch Bank of Germany, the Central Bank of Mexico, and the Bank of France.

Credit rationing may be done in two ways: firstly the central bank can impose a ceiling on the amount of borrowing by each commercial banks, this is called the variable portfolio quota on rediscount ceiling for each com-

mercial bank. Secondly, the central bank can fix the ratio of capital to total assets ratio of the commercial banks.

However, credit rationing should be employed during exceptional circumstance only, because it curtails the freedom and initiative of commercial banks, that is why the methods is very sparingly used by the central banks of almost all the countries.

17.5.4: Direct Action

Direct action implies the coercive measures initiated by a central bank against individual units of the banking organisation. Direct action has derived its significance from the fact that it implies direct dealing with individual banks. Whereas discount rate policy is applied generally and objectively to all institutions, which have to borrow from the central bank, the open market operations are characterised by their impersonal application as well as by their repercussion on banks and the money market.

Under the method, the central bank may refuse to rediscount the bills or advance loan against securities to those banks, which are not following its policy or directives. The central bank may charge a penal rate of interest on money borrowed beyond the prescribed limit.

However, the method has been criticized on the ground that it results in division of responsibility between the central bank and the commercial banks. Further, it may also be difficult for the banks to distinguish between essential and non-essential, productive and unproductive or between investment speculative and gambling activities. But in times of emergency and default by the banks the method is very useful in controlling of credit.

17.5.5: Issue of Directives

The central bank may also give directives to the commercial banks regarding the expansion or contraction of credit, which have to be followed in toto. They may be in the form of circulars, notices, warnings and general directives. Being the apex monetary institution and with wide powers to regulate, monitor and develop the monetary sector of the economy, each central bank issues directions. They usually pertain to their lending policies, purpose for which the loans are to be given, the margin required, the securities to be obtained as well as other aspects related to lending. The directives would be derived from the general economic policy of the government or the monetary policy of the central bank itself. This not only gives significance to the directives but also make them binding on the commercial banks.

17.5.6: Moral Suasion

Moral suasion as opposed to direct action does not involve coercive measures. It is a friendly persuasion of the commercial banks to follow the monetary policy of the central bank. Depending on the monetary trends, the central bank may persuade the commercial banks to adopt a specific policy related expansion of credit, margin money requirement, repayment schedule, sectors to which loans may be granted and the like. This method does not involve the unfavorable psychological reaction by the banks. But the moral suasion has founded not be so effective in regulating the credit creation by banks. As Clark says warnings without the banks as in respect of direct action do not heed to teeth. But, on the other hand, Burgess says, "the informal influence of the central bank is much more stronger than their formal action under law". Thus, it may be said that the success of this measure depends upon the relationship between the commercial banks and the central bank, and also the strength of the central bank itself.

17.6: Significance of Selective Credit Controls

Selective credit controls have now become very useful instruments of credit control due to the following reasons:

(i) they are more flexible and can be applied to the desired parts or sectors of the monetary system;

(ii) they can be used to control credit creation without affecting the general trends in the economy; and

(iii) These methods are very much suitable for restricting the demand for credit and, therefore, inflationary tendencies.

Thus, compared to the quantitative or general credit controls, the selective credit controls act selectively and are, therefore, found to be more useful in controlling inflationary trends.

17.7: Limitations of Selective Credit Controls

The selective credit controls suffer from the following limitations:

(i) They are capable of controlling only bank credit. Credit advanced by non-banking institutions is not under the purview of these methods. Similarly, other sources of financing the investments such as issue of fresh capital, undistributed profits, etc. are not influenced by the selective credit controls.

(ii) There is always the difficulty on the part of the banks regarding ensuring the proper end use of the credit lent to productive and/or essential purposes.

(iii) There is every chance that commercial banks may lend for non-productive purposes and conceal it. The central bank can not scrutinise to find out such cases.

(iv) The relationship between the central bank and the commercial banks is also an important factor determining the success of selective credit controls. If the commercial banks are conscious of their responsibilities, there will not be much problem. The sense of national responsibility evinced by the English banks is a case in point. On the other hand, in Australia, the controls have been looked upon as undue interference in their working by the commercial banks.

Check Your Progress

(i) Distinguish between quantitative and selective credit control instruments.

(ii) Discuses the advantages and limitations of selective credit control methods vis-a-vis the quantitative ones.

17.8: Selective Credit Controls in India

Selective credit controls were introduced in India in 1956. They are considered as a useful supplement to general credit regulation. They are intended to curb excess in selected area without affecting other types of credit. They aim at achieving a reasonable stablisation of prices by regulating the availability of bank credit.

Under the Banking Regulation Act, the RBI has been empowered to:

(i) give directions as to the purpose for which advances should not be made by commercial banks;

(ii) RBI can determine the margin requirement to be maintained in respect of secured advances;

(iii) RBI can by down the maximum amount of advance that can be made by a commercial bank to any one borrower;

(iv) RBI can lay down the maximum amount up to which guarantees may be given by a commercial bank; and

(v) RBI may contain or prohibit banks against entering into any particular transaction.

The major techniques of selective credit control used by the RBI are: (a) minimum margins for lending against specific securities, (b) varying the amounts of credit for certain purposes, and (c) discriminatory rates of interest charged on certain types of advances. Other than these, the RBI has also exercised its power to informally persuade (moral suasion) the commercial banks to adopt a particular style of business. RBI also regularly issues directives and publishes reports on various aspects of money, banking and finance that serve as pointers to the behaving of the commercial banks.

Check Your Progress

Find out the specific selective credit controls adopted by RBI in recent years.

17.9: Let us Sum up

The selective credit controls are being used worldwide as an adjunct to the general credit control instruments. The selective credit controls are varied in nature and are suitable to control the inflationary tendencies in the economy. When the general policy is to restrict or enhance the availability of credit, if a specific sector is to be encouraged or discouraged then selective credit controls are the better instruments. Moreover, in a developing country, the flow of credit to unproductive sectors and undesirable uses needs to be checked. Selective credit control instruments are quite useful here. Further, the American experience has clearly shown the efficacy of selective credit controls in controlling speculative credit and mitigating the swings of the business cycle. There has been an increasing realisation in every country that selective controls are essential for pursuing an effective monetary policy. The selective credit controls help in restricting credit to undesirable sectors, but enchaining the same to desired sectors. It has been rightly observed that before administering therapy to all parties of the body economic, the particular ailing part should be selected for administration of local therapy.

17.10 Questions for self study

(i) Explain the meaning and nature of selective credit control instruments.

(ii) Explain the mechanism of margin money requirements, rationing of credit and regulation of Consumer Credit

(iii) State the conditions for the success of directives and moral suasion.

(iv) Evaluate the effectiveness of selective credit control methods in pursuing an effective monetary policy.

Books For self Study

1. DeKock M.H, 1961 : Central Banking, Staples Press, London.

2. GOI, 2003 : Economic Survey, Ministry of Finance, Government of India, New Delhi.

3. Sayers R.S. 1975 : Modern Banking, Macmillan, New Delhi.

4. Shekhar K.C, 1998 : Banking Theory and Practice, Vikas Publishing House Private Limited, New Delhi.

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ಆದೇಶ ಸಂಖ್ಯೆ : ಕರಾಮುವಿ/ಸಿಪಾವಿ / 4/520/2006-2007 ದಿನಾಂಕ : 05-09-2006
ಒಳಪುಟ : 60 GSM MPM ವೈಟ್ ಪ್ರಿಂಟಿಂಗ್ ಪೇಪರ್ ಮತ್ತು ಹೊರಪುಟ : 170 GSM ಆರ್ಟ್‌ಕಾರ್ಡ್
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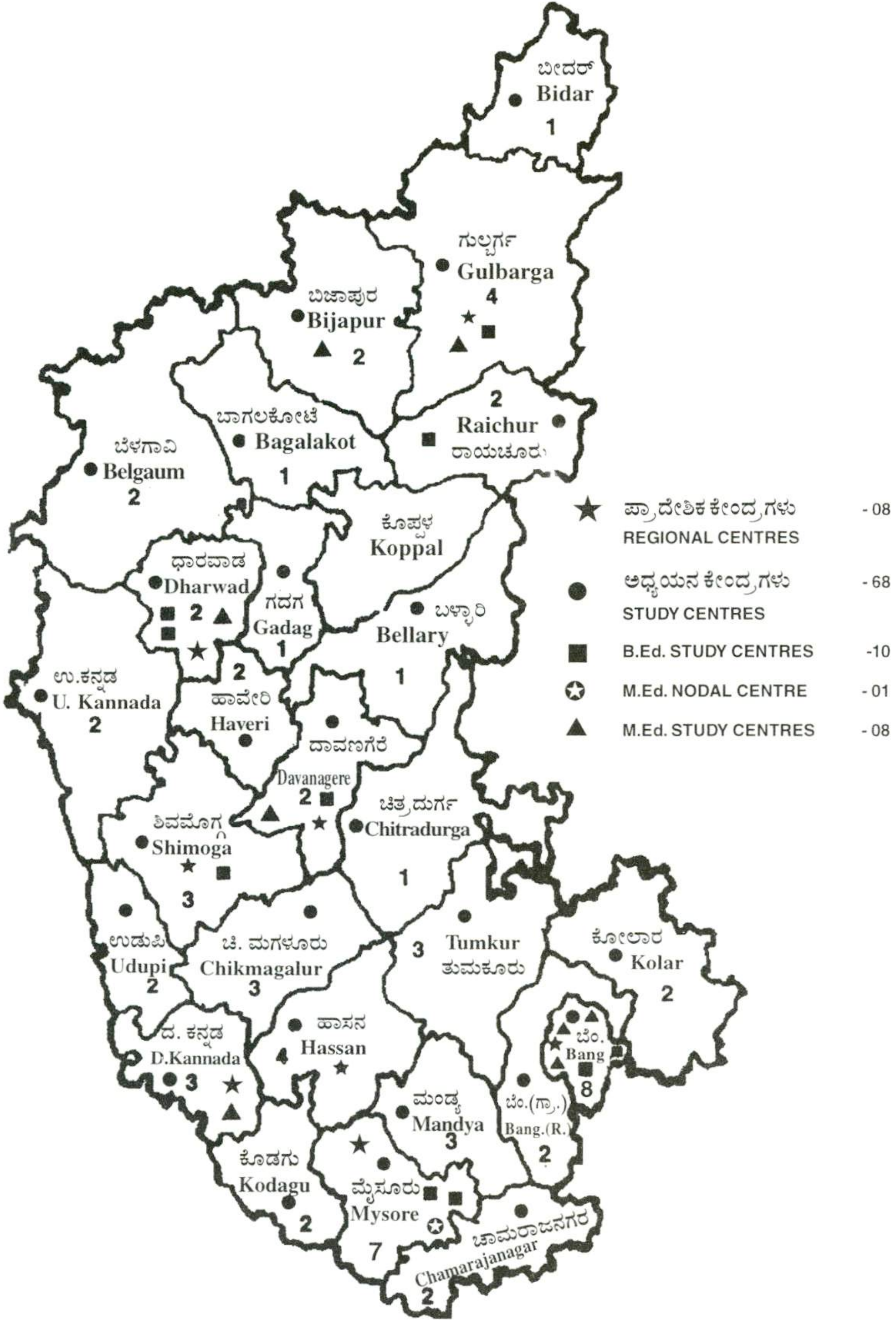

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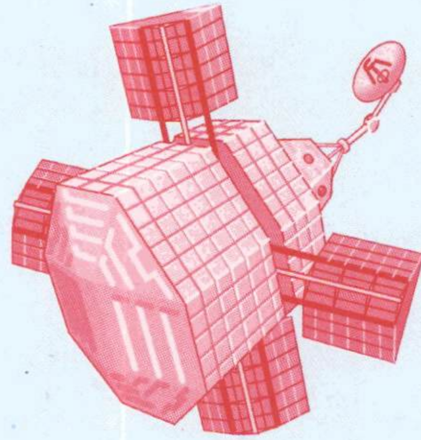

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Evaluation - methods and modes

Continuous evaluation

Feedback : improvement, revision and launching of new programmes

Systematic feedback

Unsystematic Feedback

Feedback from public

Programme guide

Course Materials

Assignments

Supplementary material

Project

*Audio and video cassettes at study centres

*Broadcasts - radio, television & teleconferencing

*Students affairs cell

Regional Director and academic staff

Coordinator and counsellors at study centres

Laboratory work/practicals

Extended contact programmes

Tutor marked assignments

Examination results

Project

STUDENT

INSTRUCTIONAL SYSTEM