Central Banking

Functions of central banks:

1. Conduct of **MONETARY POLICY:** Monetary policy refers to the use of monetary instruments under the control of the central bank to regulate magnitudes such as interest rates, money supply and availability of credit with a view to achieving the ultimate objective of economic policy.
2. Design, production and overall **MANAGEMENT OF THE NATION'S CURRENCY**, with the goal of ensuring an adequate supply of clean and genuine currency.
3. **REGULATION OF BANKS/FINANCIAL SYSTEM**: Aimed at protecting depositors' interests, orderly development and conduct of banking operations and fostering of the overall health of the banking system and financial stability.
4. **BANKER TO THE GOVERNMENT**: Managing the government's banking transactions. Manage foreign exchange reserves of the country and conduct exchange rate policy

5. BANKER’S BANK AND THE LENDER OF THE LAST RESORT

To function as a ’banker’s bank’, Banks are required to maintain a portion of their deposit liabilities as cash reserves with the Central Bank . For this purpose, they need to maintain accounts with the Central Bank and also for settling inter-bank obligations, such as, clearing transactions of individual bank customers who have their accounts with different banks or clearing money market transactions between two banks, buying and selling securities and foreign currencies. In order to facilitate a smooth inter-bank transfer of funds, or to make payments and to receive funds on their behalf, banks need a common banker. As a Banker to Banks, a Central Bank also acts as the ‘lender of the last resort’. It can come to the rescue of a bank that is solvent but faces temporary liquidity problems by supplying it with much needed liquidity when no one else is willing to extend credit to that bank. A Central Bank extends this facility to protect the interest of the depositors of the bank and to prevent possible failure of the bank, which in turn may also affect other banks and institutions and can have an adverse impact on financial stability and thus on the economy.

6. Management of foreign Exchange

- Foreign exchange availability to various economic agents
- Foreign Investment
- External Commercial Borrowings
- Remittance management
- Currency derivatives
- Exchange Rate Policy
- Foreign Exchange Reserves Management

Monetary Policy and Credit control

- Commercial bankers are profit making entities. For them creation and supply of credit is a source of profits. The total credit money supply is much in excess and a certain multiple of the cash deposits that they possess. Therefore commercial banks are likely to run into difficulties whenever their depositors suddenly increase demand for money. If the bankers are unable to satisfy the needs of their depositors then they are likely to fail and go bankrupt. The job of a central bank it is to ensure that every bank should operate successfully and overcome its difficulties. Therefore, the central bank keeps a strict control on the credit supply activities of the banks. In order to achieve its goals the central bank uses two devices. These are **quantitative and qualitative methods of credit control**.

Quantitative Credit controls
(With Special Reference to India

- Bank Rate
- Repo Rate/Reverse Repo Rate

Policy Repo Rate	: 4.00%
Reverse Repo Rate	: 3.35%
Bank Rate	: 4.25%

- Open Market Operations (OM Purchases & OM Sales)

- Reserve ratios

CRR	: 4 %
SLR	: 18.00%

- Repo Rate and Bank Rate are the two most popular rates ~~calculated for~~ borrowing and lending activities carried on by commercial and central banks. **They are the lending rates at which a Central Bank lends funds to commercial banks and other financial institutions**. While both rates are short term tools used to control the cash flow in the market and are often mistaken to be one and the same, there is some noteworthy difference between the two.
- Simply put, repo_rate is the rate at which the RBI lends to commercial banks by purchasing securities while bank rate is the lending rate at which commercial banks can borrow from the RBI without providing any security.
- **Increase in BR or RR is anti-inflationary and decrease in BR or RR is pro-growth policy.**

Key differences between Repo Rate vs Bank Rate

- Though Repo Rate and Bank Rate have few similarities like both is fixed by the central bank and used to monitor and control the cash flow in the market, they have some prominent differences too. Take a look at the differences between Repo Rate and Bank Rate below.
- Bank Rate is charged against loans offered by the central bank to commercial banks, whereas, Repo Rate is charged for repurchasing the securities sold by the commercial banks to the central bank.
- No collateral is involved while charging Bank Rate but securities, bonds, agreements and collateral is involved when Repo Rate is charged.
- Repo Rate is always lower than the Bank Rate.
- Increase in Bank Rate directly affects the lending rates offered to the customer, restricting people to avail loans and damages the overall economic growth, whereas Increase in Repo Rate is usually handled by the banks and doesn’t affect customers directly.
- Comparatively, Bank Rate caters to long term financial requirements of commercial banks whereas Repo Rate focuses on short term financial needs.
- Though Bank Rate and Repo Rate have its own differences, both are used by RBI to control liquidity and inflation in the market. In a nutshell, the central bank uses these two powerful tools to introduce and monitor the liquidity rate, inflation rate and money supply in the market.

Analytics of Bank Rate and Repo Rate

- An increase in Bank Rate is increases the cost of obtaining credit and hence, operates through the demand credit. Bank rate is supposed to act as a reference rate for determining the other interest rates of the commercial banks. In other words, an increase (decrease) in Bank Rate is indicative of contractionary (expansionary) stance of monetary/ credit policy.
- Decrease in BR: Pro-growth policy
- Increase in BR: Anti-inflationary policy
- Decrease in RR: Easing liquidity conditions in the short-run
- Increase in RR: Tightening liquidity conditions in the short-run

Cash Reserve Ratio:

- Refers to that amount of bank deposits that the banks must keep with the Central Bank in the form of cash or near-money reserves. This instrument was used as a device to protect depositors but later came to be used as a credit control measure. The reserves of the commercial banks held with the Central Bank change the amount of lendable resources of the commercial bank. An increase (reduction) in the CRR reduces (increases) the amount of lendable resources of the commercial banks, thereby, restricting (expanding) supply of credit.
- Decrease in CRR: Pro-growth policy
- Increase in CRR: Anti-inflationary policy

Statutory Liquidity Ratio:

- Refers to the amount of deposits that banks must hold in the form of government securities. This is to ensure that banks are liquid enough to meet any unforeseen withdrawals from depositors. Government securities by the virtue of being easily marketable impart liquidity to the banks.
- Decrease in SLR: Pro-growth policy
- Increase in SLR: Anti-inflationary policy
- Gilt edged securities: Securities where there is no risk. Generally govt securities are called Gilt edged securities.

Open Market Operations: Sales and Purchases

1. Open market operations is the sale and purchase of government securities and treasury bills by RBI or the central bank of the country.

2. The objective of OMO is to regulate the money supply in the economy.

3. When the RBI wants to increase the money supply in the economy, it purchases the government securities from the market (OMP) and it sells government securities to suck out liquidity from the system (OMS).

4. RBI carries out the OMO through commercial banks and does not directly deal with the public.

5. OMO is one of the tools that RBI uses to smoothen the liquidity conditions through the year and minimise its impact on the interest rate and inflation rate levels.

OMP: Growth Promotion Tool

OMS: Anti-inflationary Tool

Qualitative Tools of Credit Control

- Moral Suasion: This is in the form of a directive to the banks asking them to adhere to certain norms of lending. It seeks to obtain voluntary co-operation of the banks in meeting a certain problem.

- Margin Requirements: Margin requirements are selective credit control measures which help the RBI prevent speculative hoarding of commodities like foodgrains and essential raw materials to check undue rise in their prices. Through margin requirements, the Reserve Bank regulates the availability of credit for purchasing and holding certain sensitive commodities like sugar and wheat.