2C) ROLE of CENTRAL BANK

Reserve Bank of India

The central bank in a developing economy performs both traditional and non-traditional functions. The principal traditional functions performed by it are the monopoly of note issue, banker to the government, bankers' bank, lender of the last resort, controller of credit and maintaining stable exchange rate.

But all these functions are related to the foremost function of helping in the economic development of the country.

R*ole of Central Bank in Economic Development* **:** The central bank in a developing country aims at the promotion and maintenance of a rising level of production, employment and real income in the country. The central banks in the majority of underdeveloped countries have been given wide powers to promote the growth of such economies. They, therefore, perform the following functions towards this end.

C*reation and Expansion of Financial Institutions* **:** One of the aims of a central bank in an underdeveloped country is to improve its currency and credit system. More banks and financial institutions are required to be set up to provide larger credit facilities and to divert voluntary savings into productive channels. Financial institutions are localised in big cities in underdeveloped countries and provide credit facilities to estates, plantations, big industrial and commercial houses.

In order to remedy this, the central bank should extend branch banking to rural areas to make credit available to peasants, small businessmen and traders. In underdeveloped countries, the commercial banks provide only short-term loans. Credit facilities in rural areas are mostly non-existent. The only source is the village moneylender who charges exorbitant interest rates.

The hold of the village moneylender in rural areas can be slackened if new institutional arrangements are made by the central bank in providing short-term, medium term and long-term credit at lower interest rates to the cultivators. A network of co-operative credit societies with apex banks financed by the central bank can help solve the problem.

Similarly, it can help the establishment of lead banks and through them regional rural banks for providing credit facilities to marginal farmers, landless agricultural workers and other weaker sections. With the vast resources at its command, the central bank can also help in establishing industrial banks and financial corporations in order to finance large and small industries.

P*roper Adjustment between Demand for and Supply of Money* **:** The central bank plays an important role in bringing about a proper adjustment between demand for and supply of money. An imbalance between the two is reflected in the price level. A shortage of money supply will inhibit growth while an excess of it will lead to inflation. As the economy develops, the demand for money is likely to go up due to gradual monetization of the non-monetized sector and the increase in agricultural and industrial production and prices.

The demand for money for transactions and speculative motives will also rise. So the increase in money supply will have to be more than proportionate to the increase in the demand for money in order to avoid inflation. There is, however, the likelihood of increased money supply being used for speculative purposes, thereby inhibiting growth and causing inflation.

The central bank controls the uses of money and credit by an appropriate monetary policy. Thus in an underdeveloped economy, the central bank should control the supply of money in such a way that the price level is prevented from rising without affecting investment and production adversely.

A *Suitable Interest Rate Policy* **:** In an underdeveloped country the interest rate structure stands at a very high level. There are also vast disparities between long-term and short-term interest rates and between interest rates in different sectors of the economy. The existence of high interest rates acts as an obstacle to the growth of both private and public investment, in an underdeveloped economy.

A low interest rate is, therefore, essential for encouraging private investment in agriculture and industry. Since in underdeveloped country businessmen have little savings out of undistributed profits, they have to borrow from the banks or from the capital market for purposes of investment and they would borrow only if the interest rate is low. A low interest rate policy is also essential for encouraging public investment. A low interest rate policy is a cheap money policy. It makes public borrowing cheap, keeps the cost of servicing public debt low and thus helps in financing economic development.

In order to discourage the flow of resources into speculative borrowing and investment, the central bank should follow a policy of discriminatory interest rates, charging high rates for non-essential and unproductive loans and low rates for productive loans. But this does not imply that savings are interest-elastic in an underdeveloped economy.

Since the level of income is low in such economies, a high rate of interest is not likely to raise the propensity to save. In the context of economic growth, as the economy develops, a progressive rise in the price level is inevitable. The value of money falls and the propensity to save declines further. Money conditions become tight and there is a tendency for the rate of interest to rise automatically. This would result in inflation. In such a situation any effort to control inflation by raising the rate of interest would be disastrous. A stable price level is, therefore, essential for the success of a low interest rate policy which can be maintained by following a judicious monetary policy by the central bank.

Debt Management **:** Debt management is one of the important functions of the central bank in an underdeveloped country. It should aim at proper timing and issuing of government bonds, stabilizing their prices and minimizing the cost of servicing public debt. It is the central bank which undertakes the selling and buying of government bonds and making timely changes in the structure and composition of public debt.

In order to strengthen and stabilize the market for government bonds, the policy of low interest rates is essential. For, a low rate of interest raises the price of government bonds, thereby making them more attractive to the public and giving an impetus to the public borrowing programmes of the government. The maintenance of structure of low interest rates is also called for minimizing the cost of servicing the national debt.

Further, it encourages funding of debt by private firms. However, the success of debt management would depend upon the existence of well-developed money and capital markets in which wide range of securities exist both for short and long periods. It is the central bank which can help in the development of these markets.

Credit Control **:** Central Bank should also aim at controlling credit in order to influence the patterns of investment and production in a developing economy. Its main objective is to control inflationary pressures arising in the process of development. This requires the use of both quantitative and qualitative methods of credit control.

Open market operations are not successful in controlling inflation in underdeveloped countries because the bill market is small and undeveloped. Commercial banks keep an elastic cash-deposit ratio because the central bank's control over them is not complete. They are also reluctant to invest in government securities due to their relatively low interest rates.

Moreover, instead of investing in government securities, they prefer to keep their reserves in liquid form such as gold, foreign exchange and cash. Commercial banks are also not in the habit of rediscounting or borrowing from the central bank.

The bank rate policy is also not so effective in controlling credit in LDCs due to: (a) the lack of bills of discount; (b) the narrow size of the bill market; (c) a large non-monetised sector where barter transactions take place; (d) the existence of a large unorganised money market; (e) the existence of indigenous banks which do not discount bills with the central banks; and (f) the habit of commercial banks to keep large cash reserves.

The use of variable reserve ratio as method of credit control is more effective than open market operations and bank rate policy in LDCs. Since the market for securities is very small, open market operations are not successful. But a rise or fall in the reserve ratio by the central bank reduces or increases the cash available with the commercial banks without affecting adversely the prices of securities.

Again, the commercial banks keep large cash reserves which cannot be reduced by a raise in the bank rate or sale of securities by the central bank. But raising the cash-reserve ratio reduces liquidity with the banks. However, the use of variable reserve ratio has certain limitations in LDCs.

First, the non-banking financial intermediaries do not keep deposits with the central bank so they are not affected by it.

Second, banks which do not maintain excess liquidity are not affected than those who maintain it.
The qualitative credit control measures are, however, more effective than the quantitative measures in influencing the allocation of credit, and thereby the pattern of investment. In underdeveloped countries, there is a strong tendency to invest in gold, jewellery, inventories, real estate, etc., instead of in alternative productive channels available in agriculture, mining, plantations and industry.
The selective credit controls are more appropriate for controlling and limiting credit facilitates for such unproductive purposes. They are beneficial in controlling speculative activities in food-grains and raw materials. They prove more useful in controlling 'sectional inflations' in the economy.

They curtail the demand for imports by making it obligatory on importers to deposit in advance an amount equal to the value of foreign currency. This has also the effect of reducing the reserves of the banks in so far as their deposits are transferred to the central banks in the process. The selective credit control measures may take the form of changing the margin requirements against certain types of collateral, the regulation of consumer credit and the rationing of credit.

***S**olving the Balance of Payments Problem* **:** The central bank should also aim at preventing and solving the balance of payments problem in a developing economy. Such economies face serious balance of payments difficulties to fulfil the targets of development plans. An imbalance is created between imports and exports which continue to widen with development.

The central bank manages and controls the foreign exchange of the country and also acts as the technical adviser to the government on foreign exchange policy. It is the function of the central bank to avoid fluctuations in the foreign exchange rates and to maintain stability. It does so through exchange controls and variations in the bank rate. For instance, if the value of the national currency continues to fall, it may raise the bank rate and thus encourage the inflow of foreign currencies.

***C**onclusion* **:** Thus the central bank plays an important role in achieving economic growth of a developing country through the various measures discussed above. It should promote economic growth with stability, help in attaining full employment of resources, in overcoming balance of payments disequilibrium, and in stabilising exchange rates.

The primary function of a central bank is to control the nation's money supply (monetary policy), through active duties such as managing interest rates, setting the reserve requirement, and acting as a lender of last resort to the banking sector during times of bank insolvency or financial crisis.

A central bank, reserve bank, or monetary authority is an institution that manages a state's currency, money supply, and interest rates. Central banks also usually oversee the commercial banking system of their respective countries. In contrast to a commercial bank, a central bank possesses a monopoly on increasing the monetary base in the state, and usually also prints the national currency, which usually serves as the state's legal tender.

Central banks usually also have supervisory powers, intended to prevent bank runs and to reduce the risk that commercial banks and other financial institutions engage in reckless or fraudulent behavior. Central banks in most developed nations are institutionally designed to be independent from political interference. Still, limited control by the executive and legislative bodies usually exists.

Major functions of the RBI are as follows:

1. ***I**ssue of Bank Notes* **:** The Reserve Bank of India has the sole right to issue currency notes except one rupee notes which are issued by the Ministry of Finance. Currency notes issued by the Reserve Bank are declared unlimited legal tender throughout the country.
This concentration of notes issue function with the Reserve Bank has a number of advantages: (i) it brings uniformity in notes issue; (ii) it makes possible effective state supervision; (iii) it is easier to control and regulate credit in accordance with the requirements in the economy; and (iv) it keeps faith of the public in the paper currency.

2. ***B**anker to Government* **:** As banker to the government the Reserve Bank manages the banking needs of the government. It has to-maintain and operate the government’s deposit accounts. It collects receipts of funds and makes payments on behalf of the government. It represents the Government of India as the member of the IMF and the World Bank.

3. ***C**ustodian of Cash Reserves of Commercial Banks* **:** The commercial banks hold deposits in the Reserve Bank and the latter has the custody of the cash reserves of the commercial banks.

4. ***C**ustodian of Country’s Foreign Currency Reserves* **:** The Reserve Bank has the custody of the country’s reserves of international currency, and this enables the Reserve Bank to deal with crisis connected with adverse balance of payments position.

5. ***L**ender of Last Resort* **:** The commercial banks approach the Reserve Bank in times of emergency to tide over financial difficulties, and the Reserve bank comes to their rescue though it might charge a higher rate of interest.

6. *Central Clearance and Accounts Settlement* **:** Since commercial banks have their surplus cash reserves deposited in the Reserve Bank, it is easier to deal with each other and settle the claim of each on the other through book keeping entries in the books of the Reserve Bank. The clearing of accounts has now become an essential function of the Reserve Bank.

7. ***C**ontroller of Credit* **:** Since credit money forms the most important part of supply of money, and since the supply of money has important implications for economic stability, the importance of control of credit becomes obvious. Credit is controlled by the Reserve Bank in accordance with the economic priorities of the government.