

CHAPTER – 8

MONEY AND BANKING

Unit 1

Money

Learning Objectives

At the end of this unit, you will be able to :

- ◆ know the meaning of money.
- ◆ understand the functions of money.

1.0 MEANING OF MONEY

Money is an important and indispensable element of modern civilization. In ordinary usage, what we use to pay for things is called money. To a layman, thus, in India, the rupee is the money, in England the pound is the money while in America the dollar is the money. But to an economist, these represent merely different units of money. Then how do we define money?

Definition of Money : It is very difficult to define money in exact sense. This is because, there are various categories of assets which possess the attributes of money. Many things such as clay, cowry shells, tortoise shells, cattle, slaves, rice, wool, salt, porcelain, stone, gold, iron, brass, silver, paper and leather etc. have been used as money. Traditionally, money has been defined on the basis of its general acceptability and its functional aspects. Thus, any thing which performed the following three functions (i) served as medium of exchange (ii) served as a common measure of value and (iii) served as a store of values, was termed as money. To modern economists or empiricists, however, the crucial function of money is that it serves as a store of value. It thus includes, not only currencies and demand deposits of banks, but also includes a host of financial assets such as bonds, government securities, time deposits with banks and equity shares which serve as a store of value. Some economists categorise these financial assets as near money, distinct from pure money which refers to cash and chequeable deposits with commercial banks. The empiricists argue that whether a financial asset should be included in money should be decided on the basis of empirical investigation of the financial asset. To them, money is what money does. While clustering financial assets as money they have laid down certain criteria : (i) stability of the demand function, (ii) high degree of substitutability, and (iii) feasibility of measuring statistical variations in real economic factors influenced by the monetary policy.

1.1 FUNCTIONS OF MONEY

In a *static sense*, money serves :

- (i) **As a medium of exchange :** The fundamental role of money in an economic system is to serve as a medium of exchange or as a means of payment.

In the barter system goods are exchanged for other goods. This system prevailed throughout the world in the olden times. This system suffered from many shortcomings, the prominent being that it necessitated double coincidence of wants. For exchange of goods, persons desiring to exchange goods must specifically want those goods what others offered in exchange. Money has removed this difficulty. Now a person A can sell his goods (say clothes) to another person B for money and then can use to buy goods (say Mobile phone) he wants from others who have these goods.



- (ii) **As a unit of account** : Money is a common measure or common denominator of value. The value in exchange of all goods and services can be expressed in terms of money. We can say that it is the general language we use to quote prices and compare them. It would be possible to use any good as a unit of account (say) mobile phones. This would mean that the prices of tables, chairs, books and groceries would all be quoted in terms of the number of mobile phones required to buy them. In theory it sounds possible, but in practice who would want to carry around mobile phones to pay for everything they buy? Moreover, since there are different types of mobile phones which are available, the problem of developing an exchange rate relationship where the purchasing power of one phone would be quoted relative to another will arise. Even if prices are quoted in more basic unit, say gold, the problem of carrying gold will still remain. Moreover, some dishonest persons may shave off some of the gold from the gold coins and thus devalue them. Since we are generally not willing to accept commodities such as gold or phones as units of accounts, we require another alternative. This alternative is Fiat money.

Fiat Money : Fiat money exists where paper with no intrinsic value itself fulfils the functions of money, and government legislation ensures that it must be accepted for transaction. For example in India, rupee is the fiat money. A hundred rupee note is capable of buying goods and services worth 100 rupees, although as such the note of hundred rupees is nothing but a piece of paper.

In fact, it acts as a means of calculating the relative prices of goods and services.

- (iii) **As standard of deferred payments** : Money is a unit in terms of which debts and future transactions can be settled. Thus loans are made and future contracts are settled in terms of money.
- (iv) **As store of value** : Money being a permanent abode of purchasing power holds command over goods and services all the times-present and future. Money is a convenient means of keeping any income which is surplus to immediate spending needs and it can be exchanged for the required goods and services at any time. Thus it acts as a store of value.

In *dynamic sense*, money serves the following functions :

- (v) **Directs economic trends** : Money directs idle resources into productive channels and there by affects output, employment, consumption and consequently economic welfare of the community at large.
- (vi) **As encouragement to division of labour** : In a money economy, different people tend to specialise in the different goods and through the marketing process, these goods are bought and sold for the satisfaction of multiple wants. In this way, occupational specialisation and division of labour are encouraged by the use of money.
- (vii) **Smoothens transformation of savings into investments** : In a modern economy, savings and investments are done by two different sets of people - households and firms. Households save and firms invest. Households can lend their savings to firms. The mobilisation of savings can be done through the working of various financial institutions such as banks. Money so borrowed by the investors when used for buying raw materials, labour, factory plant etc. becomes investment. Saved money thus can be channelised into any productive investment.

1.2 MONEY STOCK IN INDIA

In 1979 the RBI classified money stock in India in the following four categories.

M_1 = Currency with the public i.e., coins and currency notes + Demand deposits of the public known as narrow money.

M_2 = M_1 + Post office saving deposits.

M_3 = M_1 + Time deposits of the public with banks called broad money.

M_4 = M_3 + Total post office deposits. (excluding National Saving Certificates)

The basic distinction between narrow money (M_1) and broad money (M_3) is in the treatment of time deposits with banks. Narrow money excludes time deposits of the public with the banking system while broad money includes it. Not much significance is attached to M_2 and M_4 by the RBI. The third RBI working group (1998) redefined its parameters for measuring money supply and introduced new monetary aggregates (NM).

NM_1 = Currency + Demand deposits + Other deposits with RBI.

NM_2 = NM_1 + Time liabilities portion of saving deposits with banks + Certificates of deposits issued by banks + Term deposits maturing within a year excluding FCNR (B) (Foreign Currency now Residential Bank) Deposits.

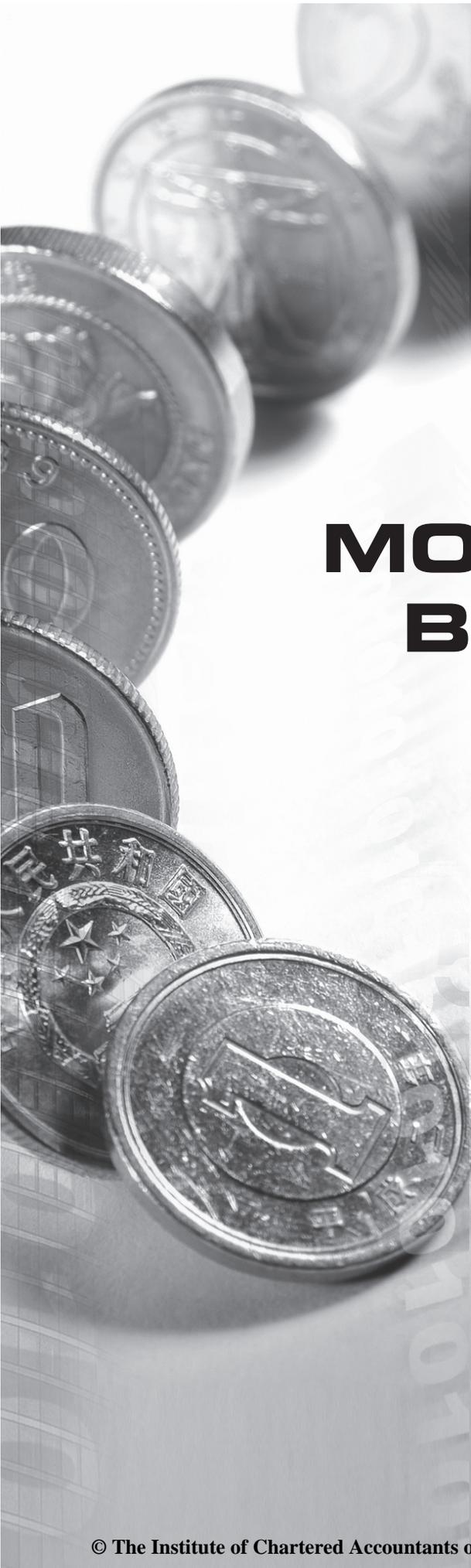
NM_3 = NM_2 + Term deposits with banks with maturity over one year + Call / term borrowings of the banking system.

NM_4 has been excluded from the scheme of new monetary aggregates. Three liquidity aggregates L_1 , L_2 and L_3 have also been introduced.

It may, however be noted that the measures M_1 , and M_3 are still used as measures of money supply in India.

SUMMARY

- Money is an important and indispensable element of modern civilization. In ordinary practice, what we use to pay for things is called money.
- In the traditional sense, money serves as medium of exchange, measure of value, store of value and standard of deferred payment.
- In the modern economics, it serves dynamic functions like encouragement to division of labour, proper way of transferring the savings into investment and investing in productive channels.
- The money stock in India is divided into narrow money and broad money. Narrow money excludes time deposits of the public with the banking system while broad money includes it.



CHAPTER – 8

MONEY AND BANKING

Unit 2

Commercial Banks

Learning Objectives

At the end of this unit, you will be able to :

- ◆ understand the meaning of commercial banks and their role in India.
- ◆ understand the functions carried out by commercial banks.
- ◆ know about developments in commercial banking in India.

2.0 INTRODUCTION

A modern industrial society cannot be run by self-financing of entrepreneurs. Some institutional assistance is necessary to mobilise the savings of the community and to make them available to the entrepreneurs. The people, a large majority of who save in small odd lots, also want an institution which can ensure safety of their funds together with liquidity. Banks assure this with a further facility - that the funds can be drawn back in case of need.

From a broader social angle, banks act as a bridge between the users of capital and those who save but cannot use the funds themselves. The idle resources of the community are thus activated and brought to productive use.

Besides, the banking system has capacity to add to the total supply of money by means of credit creation. The bank is a dealer in credit - its own and other people's. It is because of the ability to manipulate credit that banks are used extensively as a tool of monetary policy.

2.1 ROLE OF COMMERCIAL BANKS

Banks play a very useful and dynamic role in the economic life of every modern state. Their economic importance may be viewed in the followed points :

- (1) A developing economy needs a high rate of capital formation to accelerate the tempo of economic development. But the economic development depends upon the rate of savings. Banks offer facilities for keeping savings and thus encourage the habits of thrift in the society.
- (2) Not only do the banks encourage savings but they also mobilise savings done by several households and make them available for production and investment to the entrepreneurs in various sectors of the economy. Without banks these savings would have remained idle and would not have been utilised for productive and investment purposes.
- (3) Allocation of funds or economic surplus among different sectors, users or producers so as to make maximum social return and thus to ensure optimum utilization of savings is another important function performed by the banks. However, it may be mentioned, that commercial banks do not always work and allocate resources in the way that maximises production or social welfare. For example, before nationalisation in 1969, the commercial banks in India neglected socially highly desirable sectors such as agriculture, small scale industries and weaker sections of the society. Therefore, it was thought necessary to nationalise them so that they should allocate resources in socially desirable directions.



- (4) By encouraging savings and mobilising them from public, banks help to increase the aggregate rate of investment in the economy. Banks not only mobilise saved funds from the public, but they also themselves create deposits or credit which serve as money. The new deposits are created by the banks when they lend money to the investors or other users. These deposits are created by the banks in excess of the cash reserves they obtain through deposits from the public. These days, the bank deposits, especially demand deposits are as much good money as the currency issued by the government or the central bank. This creation of credit, if it is used for productive purposes greatly enlarges production and investment and thus promotes economic growth.

2.2 FUNCTIONS OF A BANK

The functions of a bank can be summarised as follows :

- (a) **Receipt of deposits** : A bank receives deposits from individuals, firms, and other institutions. Deposits constitute the main resources of a bank. Such deposits may be of different types. Deposits which are withdrawable on demand are called demand or current deposits, others are called time deposits. Savings deposits are those from which withdrawals are not restricted as regards the amount and the period. Deposits withdrawable after the expiry of an agreed period are known as fixed deposits. Interest paid by banks is different for each kind of deposit - highest for fixed deposits and lowest or even nil for current deposits.
- (b) **Lending of money** : Banks lend money mainly for industrial and commercial purposes. This lending may take the form of cash credits, overdrafts, loans and advances, or discounting of bills of exchange. Interest charged by banks on such lending varies according to the amount and period involved, social priority-nature of security offered, the standing of the borrower, etc.
- (c) **Agency services** : A bank renders various services to consumers, such as : (i) collection of bills, promissory notes and cheques; (ii) collection of dividends, interests, premiums, etc.; (iii) purchase and sale of shares and securities; (iv) acting as trustee or executor when so nominated; and (v) making regular payments such as insurance premiums.
- (d) **General services** : A modern bank performs many services of general nature to the public, e.g. (i) issue of letters of credit, travellers cheques, bank drafts, circular notes; etc. (ii) safe keeping of valuables in safe deposit vaults; (iii) supplying trade information and statistics; conducting economic surveys; and (iv) preparation of feasibility studies, project reports, etc. Banks in some foreign countries also underwrite issue of shares and make loans for long-term purposes.

With development in technology, new methods of banking have been evolved. Now people have the benefit of banking anytime and anywhere. Important tools of modern banking are Automatic Telling Machine (ATM), Real Time Gross Settlement (RTGS) and the National Electronic Funds Transfer (NEFT).

An automated or automatic teller machine (ATM) also known as an automated banking machine (ABM) is a computerized telecommunications device that enables the clients of a financial institution to perform financial transactions without the need for a cashier,

human clerk or bank teller. Banks issue ATM card to its customers which, generally, is a plastic card with magnetic strip. Using ATM and ATM card, customers can access their bank accounts in order to make cash withdrawals and check their account balances.

Nowadays, transactions which are bulk and repetitive in nature are routed through electronic clearing service (ECS). India has two main electronic funds settlement systems for one to one transactions: the Real Time Gross Settlement (RTGS) and the National Electronic Funds Transfer (NEFT) systems.

Real Time Gross Settlement (RTGS): RTGS system is a funds transfer mechanism where transfer of money takes place from one bank to another on a 'real time' and on 'gross' basis. This is the fastest possible money transfer system through the banking channel. Settlement in 'real time' means payment transaction is not subjected to any waiting period. The transactions are settled as soon as they are processed. In India, the Reserve Bank of India (India's Central Bank) maintains this payment network. Core Banking enabled banks and branches are assigned an Indian Financial System Code (IFSC) for RTGS and NEFT purposes. This is an eleven digit alphanumeric code and unique to each branch of bank. The first four letters indicate the identity of the bank and remaining seven numerals indicate a single branch. This code is provided on the cheque books, which are required for transactions along with recipient's account number.

National Electronic Fund Transfer (NEFT): The National Electronic Fund Transfer (NEFT) system is a nation-wide system that facilitates individuals, firms and corporates to electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country. NEFT requires Indian financial system code (IFSC) to perform a transaction.

2.3 COMMERCIAL BANKING IN INDIA

At the time of Independence, India had a fairly well-developed banking system with more than 645 Banks having more than 4800 branch offices. These banks although developed but they could not conform to social needs of the society. These banks generally catered to the needs of industries and that too big ones. Other priority sectors like agriculture, small-scale industries, exports etc., were almost neglected. To overcome these deficiencies, the Government announced the nationalisation of 14 major commercial banks with effect from July, 1969. The objectives of nationalisation were to bring in financial discipline and to meet progressively the needs of development of the economy, in conformity with national policy and objectives. Six more banks were nationalised in 1980. (Two banks were merged in 1993, so at present there are 19 nationalised banks).

Commercial banks in India include Scheduled banks (banks which have been included in the Second Schedule of RBI Act 1934) and Non Scheduled banks (banks which are not included in the Second Schedule of RBI Act 1934, e.g. some local area banks). Scheduled banks are further divided into public sector banks (banks in which majority of stake is held by the government, e.g. State Bank of India, Union Bank, etc), private sector banks (banks in which majority of stake is held by private individuals, e.g. ICICI, HDFC, etc. and foreign banks (banks with head office outside the country in which they are located, e.g. Citi Bank, Bank of America).



Most of the public sector banks are nationalized banks (e.g. Bank of India, Punjab National Bank). But State Bank of India and its associates are public sector banks but they are not nationalized.

2.4 NATIONALISATION OF COMMERCIAL BANKS

The following factors were responsible for nationalisation of commercial banks in 1969.

- (i) **Private ownership of commercial banks and concentration of economic power** : Until nationalisation, all major banks were controlled by one or more business houses. These business houses used the resources contributed by the mass of the people for their own personal benefits. They financed those projects which ultimately enhanced their own financial resources. Thus, private ownership of banks resulted in concentration of income and wealth in few hands.
- (ii) **Urban-bias** : Prior to nationalisation, commercial banks had shown no interest in establishing offices in semi-urban and rural areas. More and more branches were opened in cities resulting in concentration of banking facilities in urban areas. For example, out of about 5.6 lakh villages in India, only 5000 were being served by commercial banks and five major cities (Ahmedabad, Bombay, Calcutta, Delhi and Madras) together had one-seventh share in the number of bank offices and about fifty percent share of bank deposits and bank credit. This urban biased nature of commercial banks led to slow rate of growth in the rural areas.
- (iii) **Neglect of agricultural sector** : There was a total neglect of the agricultural sector and its finance prior to nationalisation of banks. The banks increasingly advanced finances to commerce and industry. Agriculture accounted for only 2.2 per cent of the total advances.
- (iv) **Violation of norms** : Commercial banks often violated the norms and priorities laid down in the plans and granted loans to even those industries which figured nowhere in the priority list.
- (v) **Speculative activities** : Private commercial banks earned large profits and indulged in speculative activities. They even extended advances to hoarders and black marketers against high rates of interest.
- (vi) **Neglect of priority sectors** : Not only there was a complete neglect of agricultural sector, other sectors such as export, small-scale industries etc. were also completely neglected.

In order to discipline the commercial banks so that they do not overlook the national priorities, nationalisation of banks was undertaken first in 1969 and then in 1980.

Objectives of nationalisation : Nationalisation was meant for an early realisation of the objectives of social control which were as follows :

- (i) removal of control by a few;
- (ii) provision of adequate credit for agriculture and small industry and export;
- (iii) giving a professional bent to management;
- (iv) encouragement of a new class of entrepreneurs; and
- (v) the provision of adequate training as well as terms of services for bank staff.

2.5 PROGRESS OF COMMERCIAL BANKS AFTER NATIONALISATION

After the nationalisation of banks in 1969, commercial banking operations have become an integral part of India's economic policy. Following development have taken place since nationalisation in 1969 :

- (i) **Expansion of branches** : There has been an unprecedented growth in the branch network since nationalisation. Compared to just 8262 branch offices in 1969, the number of branch office of scheduled commercial banks in 2012 has increased to 1,11,723 indicating a greater access to banking facilities to the common man. As a result, the population per bank office has reduced from 55,000 in 1969 to less than 12000 in 2013.
- (ii) **Branch opening in rural and unbanked areas** : There has been a qualitative change in branch expansion programme ever since the nationalisation of banks. Before nationalisation, there was a clear urban bias in the operations of banks. But after nationalisation they have started moving towards rural and less developed areas. This will be clear from the fact that compared to just 22 per cent commercial bank offices in rural areas in 1969, the percentage of rural branches bank improved to about 38 per cent in June, 2013. This has helped in checking imbalances in disbursement of banking finance in India.
- (iii) **Deposit mobilisation** : There has been a substantial rise in the rate of deposit mobilisation since nationalisation. The aggregate deposits of scheduled commercial banks have increased from ₹ 4,665 crore in 1969 to more than ₹ 79,30,000 crore in 2014. Considering state-wise deposit mobilisation, we find Maharashtra leads all other states and accounts for 22 per cent of the aggregate deposits received by the banks. It is followed by Delhi, Uttar Pradesh, West Bengal, Karnataka, Andhra Pradesh and Tamil Nadu.
- (iv) **Bank lending** : There has been a spectacular rise in the Scheduled commercial banks lending since nationalisation of banks in 1969. It has gone up from ₹ 3,399 crore in June, 1969 to about ₹ 60,00,000 crore in April, 2014.

Banks have taken special care of the priority sectors in their lending operations. In 1969, agriculture, small scale industries and small retail trade accounted for about 15 per cent of the commercial banks credit. This percentage has gone up to about 36 per cent in March, 2013.

- (v) **Promotion of new entrepreneurship** : Banks, of late, have been financing the schemes which promote entrepreneurship. For example, they have been activity participating in schemes such as JRY, NRY, etc. Moreover, in their lending operations they now give high priority to the relevance of the project for the economy as a whole along with genuine business productive requirements of the borrowers.

2.6 SHORTCOMINGS OF COMMERCIAL BANKING IN INDIA

- (i) Although the commercial banks have spread their wings to every corner of the country, but considering the huge population of India, their growth in numerical terms is insufficient. This is specially so with regard to rural areas who have just 38 per cent of the bank branches but where more than 70 per cent of the population of the country reside.



- (ii) There are regional imbalances in the coverage of bank offices. Only few states have well developed banking facilities : *Arunachal Pradesh, Jammu and Kashmir, Uttaranchal, Manipur, Tripura* on an average have lesser number of banks compared to other states. Even from the states which are well banked like Maharashtra, West Bengal and Tamil Nadu, if big metropolitan cities are excluded the population per bank office is larger than the average for these states.
- (iii) As a result of increasing advances and loans to unemployed and weaker sections the commercial banks are facing the problem of bad debts, doubtful debts and over dues. *This seriously affects the process of recycling of funds by the commercial banks. Bad and doubtful debts of scheduled commercial banks, called non-performing assets (NPAs) have swelled over a period of time. Gross NPAs as a percentage of Gross Advances were more than 10 percent till 2001-02, but due to stringent credit norms and improved financial health of the economy the gross NPAs have fallen. As a percentage of gross advances, they have fallen from 10.5 per cent in 2001-02 to 3.6 per cent in 2012-13.*
- (iv) There is a problem of effective management and control especially over the branches which are located in remote areas. This has hampered the overall efficiency of the commercial banks.
- (v) The absolute profits of the banks are rising but the profitability ratio (in terms of return on investment, return on equity) has *not improved much*. Six factors have been identified for declining trends in profitability. These are (i) lower interest on Government borrowings from banks (ii) subsidisation of credit to priority sector (iii) rapid branch expansion (iv) locking up of funds in low-term low yielding securities resulting from directed credit programmes of banks (v) lack of competition (vi) Increasing expenditure resulting from over staffing and mushrooming of branches some of which are non-viable.

Concerned with the problem of declining profitability and high incidence of non performing assets (NPA), the RBI has started fine-tuning its regulatory and supervisory mechanism. Measures have been taken to reduce NPAs. These include, reschedulement, restructuring at the bank level, framing of early warning system guidelines, corporate debt restructuring and recovery through Lok Adalats, civil courts and debt recovery tribunals.

- (vi) The public sector banks although entered into merchant banking and agricultural financing, yet they lack expertise in these areas. There is a need for professional touch in these areas.

To sum up, although after nationalisation the commercial banks have played an important role in achieving national goals of the economy yet these is a need for :-

- (a) Spreading their activities to the untouched remote corners of the country.
- (b) Keeping up their profitability.
- (c) Looking after the growing needs of the priority sectors of the economy.
- (d) Improving the performance of rural/semi-urban branches.
- (e) Improving the quality of loan portfolio.

SUMMARY

- Banks play a very useful and dynamic role in the economic life of every modern state.
- Commercial banks encourage savings habits among the people, help improving the capital formation in the economy and mobilizing the savings in a productive manner.
- Lending and borrowing functions of banks result in credit creation in the economy.
- The main functions of commercial banks are receipts of deposits, lending of money for industrial and commercial purposes, agency services to consumers and general services like travelers cheques, bank drafts, circular notes etc.
- In order to have social control on banks and channelise funds to priority sectors banks were nationalized in 1969 and 1980. Due to this effort, banks have spread their wings all over the country.
- After the nationalization of banks in 1969, expansion of branches, concentration of banks in rural areas and promotion of new entrepreneurship etc. have taken place
- Even after nationalization, there are many shortcomings likes inter-regional imbalances, inter-sectoral imbalances, mounting bad and doubtful debts and poor quality of services etc. These need to be addressed.



CHAPTER – 8

MONEY AND BANKING

Unit 3

The Reserve Bank of India (RBI)

Learning Objectives

At the end of this unit, you will be able to :

- ◆ know the meaning of Central Bank.
- ◆ understand the basic functions of a Central Bank.
- ◆ understand how a Central Bank is different a commercial bank.
- ◆ know the role and functions of Reserve Bank of India.

3.0 MEANING AND FUNCTIONS OF A CENTRAL BANK

A Central Bank is one which constitutes the apex of the monetary and banking structure of a country and which performs, in the national economic interest, the following functions :

1. The regulation of currency in accordance with the requirements of business and the general public.
2. The performance of general banking and agency services for the State.
3. The custody of cash reserve of the commercial banks.
4. The custody and management of the nation's reserves of international currency.
5. The granting of accommodation, in the form of rediscounting or collateral advances to commercial banks, bill brokers and dealers.
6. The clearance arrangements among banks; and
7. The control of credit in accordance with the needs of business with a view to carrying out broad monetary policy adopted by the State.

The above is quite comprehensive but, in addition, central banks perform additional functions to meet the specific requirements of the country. Broadly speaking, a central bank has three objectives, namely monetary stability, including stability of domestic price levels, maintenance of the international value of the nation's currency and issue of currency.

3.1 CENTRAL BANK VS COMMERCIAL BANK

Whereas other banks are largely profit seeking institutions, the central bank is not so. Although, it makes huge contribution to be general revenues, its objective is not to make profit. It does not allow interest on deposits. Its profits are mainly through its dealings in Government securities which it holds in reserve against note issue and interest on advances and loans which it grants to State Governments and other financial institutions, including commercial banks.

The Central Bank acts as the organ of the State. The ultimate responsibility of framing and executing economic policies is that of the State and, therefore, the Central Bank has to advance the policies of the State. For that purpose, the Central Bank has to act in close collaboration with the Finance Ministry and other economic ministries.



Whereas other banks have largely public dealings, the Central Bank's dealings are with Governments, Central and State banks and other financial institutions.

Whereas other banks mobilise savings and channelise them into proper use, the Central Bank's role is to ensure that the other banks conduct their business with safety, security and in pursuance of the national plan priorities and objectives of economic and social development.

3.2 ROLE OF THE RESERVE BANK OF INDIA

The Reserve Bank of India (RBI) is the Central Bank of India and occupies a pivotal position in the Indian economy. Its role is summarised in the following points:

- The RBI is the apex monetary institution of the highest authority in India. Consequently, it plays an important role in strengthening, developing and diversifying the country's economic and financial structure.
- It is responsible for the maintenance of economic stability and assisting the growth of the economy.
- It is India's eminent public financial institution given the responsibility for controlling the country's monetary policy.
- It acts as an advisor to the government in its economic and financial policies, and it also represents the country in the international economic forums.
- It also acts as a friend, philosopher and guide to commercial banks. In fact, it is responsible for the development of an adequate and sound banking system in the country and for the growth of organised money and capital markets.
- India being a developing country, the RBI has to keep inflationary trends under control and to see that main priority sectors like agriculture, exports and small scale industry get credit at cheap rates.
- It has also to protect the market for government securities and channelise credit in desired directions.

3.3 FUNCTIONS OF RESERVE BANK OF INDIA

The Reserve Bank of India being the Central Bank of India performs all the central banking functions. These are :

- (i) **Issue of currency** : The RBI is the sole authority for the issue of currency in India other than one rupee coins and notes and subsidiary coins, the magnitude of which is relatively small.
- (ii) **Banker to the government** : As a banker to the government, the RBI performs the following functions :
 - (a) It transacts all the general banking business of the Central and State Governments. It accepts money on account of these governments and makes payment on their behalf and carries out other banking operations such as their exchange and remittances.

- (b) It manages public debt and is responsible for issue of new loans. For ensuring the successes of the loan operations it actively operates in the gilt-edged market and advises the government on the quantum, timing and terms of new loans.
- (c) It also sells Treasury Bills on behalf of the Central Government in order to wipe away excess liquidity in the economy.
- (d) The RBI also makes advances to the Central and State Governments which are repayable within 90 days from the date of advance.
- (e) The RBI also acts as an adviser to the government not only on policies concerning banking and financial matters but also on a wider range of economic issues including those in the field of planning and resource mobilisation. It has a special responsibility in respect of financial policies and measures concerning new loans, agricultural finance and legislation affecting banking and credit and international finance.

(iii) **Banker's Bank** : The RBI has been vested with extensive power to control and supervise commercial banking system under the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949. All the scheduled banks are required to maintain a certain minimum of cash reserve ratio with the RBI against their demand and time liabilities. This provision enables the RBI to control the credit position of the country.

The RBI provides financial assistance to scheduled banks and state cooperative banks in the form of discounting of eligible bills and loans and advances against approved securities.

The RBI also conducts inspection of the commercial banks and calls for returns and other necessary information from banks.

(iv) **Custodian of Foreign Exchange Reserves** : The RBI is required to maintain the external value of the rupee. For this purpose it functions as the custodian of nation's foreign exchange reserves. It has to ensure that normal short-term fluctuations in trade do not affect the exchange rate. When foreign exchange reserves are inadequate for meeting balance of payments problem, it borrows from the IMF.

The RBI has the authority to enter into exchange transactions on its own account and on account of government. It also administers exchange control of the country and enforces the provisions of Foreign Exchange Management Act.

(v) **Controller of Credit** : Credit plays an important role in the settlement of business transactions and affects the purchasing power of people. The social and economic consequences of changes in the purchasing power are serious, therefore, it is necessary to control credit. Controlling credit operations of banks is generally considered to be the principal function of a central bank. The RBI, like any other Central Bank, possesses power to use almost all qualitative and quantitative methods of credit controls. (For details discussion on instruments of credit controls please refer to the topic Indian Monetary Policy).

(vi) **Promotional Functions** : Apart from the traditional functions of a Central Bank, the RBI also performs a variety of developmental and promotional functions. It is responsible for promoting banking habits among people and mobilising savings from every corner of the country. It has also taken up the responsibility of extending the banking system territorially



and functionally. Initially, it had also taken up the responsibility for the provision of finance for agriculture, trade and small industries. But now these functions have been handed over to NABARD, EXIM Bank and SIDBI respectively. The Reserve Bank is responsible for over all credit and monetary policy of the economy.

(vii) **Collection and publication of Data** : It has also been entrusted with the task of collection and compilation of statistical information relating to banking and other financial sectors of the economy.

3.4 INDIAN MONETARY POLICY

Monetary Policy is usually defined as the Central Bank's policy pertaining to the control of the availability, cost and use of money and credit with the help of monetary measures in order to achieve specific goals. In the Indian context, monetary policy comprises those decisions of the government and the Reserve Bank of India which directly influence the volume and composition of money supply, the size and distribution of credit, the level and structure of interest rates, and the effects of these monetary variables upon related factors such as savings and investment and determination of output, income and price.

The broad concerns of monetary policy in India have been -

- (a) to regulate monetary growth so as to maintain a reasonable degree of price stability and
- (b) to ensure adequate expansion in credit to assist economic growth;
- (c) to encourage the flow of credit into certain desired channels including priority and the hitherto neglected sectors; and
- (d) to introduce measures for strengthening the banking system and creating institutions for filling credit gaps.

Monetary policy is implemented by the RBI through the instruments of credit control. Generally two types of instruments are used to control credit.

These are (i) quantitative or general measures and (ii) qualitative or selective measures. The quantitative measures are directed towards influencing the total volume of credit in the banking system without special regard for the use to which it is put. Selective or qualitative instruments of credit control, on the other hand, are directed towards the particular use of credit and not its total volume.

I. Quantitative or General Measures : Quantitative weapons have a general effect on credit regulation. They are used for changing the total volume of credit in the economy. Quantitative measures consist of (a) Bank Rate Policy (b) Open Market Operations and (c) Variable Reserve Requirements.

- (a) **Bank Rate Policy** : It is the traditional weapon of credit control used by a Central Bank. The Bank Rate is the rate at which the Central Bank discounts the bills of commercial banks. When the Central Bank wishes to control credit and inflation in the economy, it raises the Bank Rate. Increased Bank Rate increases the cost of borrowings of the commercial banks who in turn charge a higher rate of interest from their borrowers. This means the price of credit will increase. This will affect the profits

of the business community who will feel discouraged to borrow. As a result, the demand for credit will go down. Decreased demand for credit will slow down investment activities which in turn will affect production and employment. Consequently, income in general will fall, people's purchasing power will decrease and aggregate demand will fall and prices will fall down. This in turn will lead to a cumulative downward movement in the economy.

On the other hand, if the Central Bank wishes to boost production and investment activities in the economy, it will decrease the Bank Rate. Decreasing the Bank Rate will have a reverse effect. As regards Bank Rate in India, it was 10 percent in 1981, 12 percent in 1991, which was reduced (in stages) to 6 per cent in 2003. However, it was increased to 9 per cent (in stages) in 2014 in order to control inflationary trends in India.

- (b) *Open market operations* : Open market operations imply deliberate direct sales and purchases of securities and bills in the market by the Central Bank on its own initiative to control the volume of credit. When the Central Bank sells securities in the open market, other things being equal, the cash reserves of the commercial banks decrease to the extent that they purchase these securities. In effect, the credit-creating base of commercial banks is reduced and hence credit contracts. On the other hand, open market purchases of securities by the Central Bank lead to an expansion of credit made possible by strengthening the cash reserves of the banks. Thus, on account of open market operations, the quantity of money in circulation changes. This tends to bring about changes in money rates. An increase in the supply of money through open market operations causes a downward movement in the interest rates, while a decrease of money supply raises interest rates. Change in the rate of interest in turn tends to bring about the desired adjustments in the domestic level of prices, costs, production and trade.
- (c) *Variable reserve requirements* : The Central Bank also uses the method of variable reserve requirements to control credit. There are two types of reserves which the commercial banks are generally required to maintain (i) Cash Reserve Ratio (ii) Statutory Liquidity Ratio (SLR). Cash reserve ratio refers to that portion of total deposits which a commercial bank has to keep with the Central Bank in the form of cash reserves. Statutory liquidity ratio refers to that portion of total deposits which a commercial bank has to keep with itself in the form of liquid assets *viz - cash, gold or approved government securities*. By changing these ratios, the Central Bank controls credit in the economy. If it wants to discourage credit in the economy, it increases these ratios and if it wants to encourage credit in the economy, it decreases these ratios. Raising of the reserve rates will reduce the surplus cash reserves of the banks which can be offered for credit. This will tend to contract credit in the system. Reverse will be effects of reduction in the reserve ratio requirements reflected in the expansion of the bank credit. At present, (September 2014) cash reserve ratio is 4 per cent and statutory liquidity ratio is 22 per cent for entire net demand and time liabilities of the scheduled commercial banks.



(d) **Repo Rate and Reverse Rate:** In addition to these, there are tools of Repo and Reverse Repo Rates. Repo rate is the rate at which our banks borrow rupees from RBI. Whenever the banks have any shortage of funds they can borrow it from RBI. RBI lends money to bankers against approved securities for meeting their day to day requirements or to fill short term gap. A reduction in the repo rate will help banks to get money at a cheaper rate. When the repo rate increases borrowing from RBI becomes more expensive. At present, Repo rate is 8 per cent. (September 2014)

Reverse Repo rate is the rate at which Reserve Bank of India (RBI) borrows money from banks. An increase in Reverse repo rate can cause the banks to transfer more funds to RBI due to this attractive interest rates. It can cause the money to be drawn out of the banking system. At present Reverse Repo rate is 7 per cent. (September 2014)

II. **Qualitative or Selective Measures :** Qualitative or selective measures are generally meant to regulate credit for specific purposes. The Central Bank generally uses the following forms of credit control -

- (a) **Securing loan regulation by fixation of margin requirements :** The Central Bank is empowered to fix the margin and thereby fix the maximum amount which the purchaser of securities may borrow against those securities. Raising of margin curbs the borrowing capacity of the security holder. This is a very effective selective control device to control credit in the speculative sphere without, at the same time, limiting the availability of credit in other productive fields. This device is also useful to check inflation in certain sensitive spots of the economy without influencing the other sectors.
- (b) **Consumer credit regulation :** The regulation of consumer credit consists of laying down rules regarding down payments and maximum maturities of installment credit for the purchase of specified durable consumer goods. Raising the required down payment limits and shortening of maximum period tend to reduce the demand for such loans and thereby check consumer credit.
- (c) **Issue of directives :** The Central Bank also uses directives to various commercial banks. These directives are usually in the form of oral or written statements, appeals, or warnings, particularly to curb individual credit structure and to restrain the aggregate volume of loans.
- (d) **Rationing of credit :** Rationing of credit is a selective method adopted by the Central Bank for controlling and regulating the purpose for which credit is granted or allocated by commercial banks.
- (e) **Moral suasion :** Moral suasion implies persuasion and request made by the Central Bank to the commercial banks to co-operate with the general monetary policy of the former. The Central Bank may also persuade or request commercial banks not to apply for further accommodation from it or not to finance speculative or non-essential activities. Moral suasion is a psychological means of controlling credit; it is a purely informal and milder form of selective credit control.
- (f) **Direct Action :** The Central Bank may take direct action against the erring commercial banks. It may refuse to rediscount their papers, and give excess credit, or it may

charge a penal rate of interest over and above the Bank Rate, for the credit demanded beyond a prescribed limit.

By making frequent changes in monetary policy, it ensures that the monetary system in the economy functions according to the nation's needs and goals.

SUMMARY

- The overall control of the monetary and banking structure of a country lies the Central Bank of a country.
- The main differences between the commercial and central bank are :
 - Commercial bank is largely profit seeking institution and deals with public.
 - Central bank is not a profit seeking institution and it deals with governments, central and state banks and other financial institutions.
- The main functions of Central Bank are note issue, banker for the government, credit control, custodian of cash reserves, lender of the last resort etc.
- India's central bank is 'The Reserve Bank of India'. It performs all the above functions.
- Monetary policy is implemented by RBI through the instruments of Credit Control.
- There are two instruments of credit control, Quantitative or General Measures and Qualitative or Selective measures.
- **Quantitative or General Measures:**
 - These are directed towards influencing the total volume of credit in the banking system without special regard for the use to which they are put.
 - Quantitative weapons have a general effect on credit regulating.
 - Quantitative measures consist of bank rate policy, open market operations and variable reserve requirements.
 - The Statutory Liquidity Ratio (SLR) refers to that portion of total deposits which a commercial bank has to keep with itself in the form of liquid assets.
 - The Cash Reserve Ratio (CRR) refers to that portion of total deposits which a commercial bank has to keep with the Central Bank in the form of cash reserves.
- **Qualitative or Selective Measures :**
 - These are directed towards the particular use of credit and not its total volume.
 - These are generally meant to regulate credit for specific purposes.
 - Qualitative measures consist of consumer credit regulation, issue of directives, rationing of credit, moral suasion, direct action etc.
- Credit policy is amended from time to time to suit the needs of the economy.



MULTIPLE CHOICE QUESTIONS

1. Money in traditional sense :
 - a. Serves as a medium of exchange.
 - b. Serves as a store of value.
 - c. Serves as both medium of exchange and store of value.
 - d. Serves neither as medium of exchange and store of value.

2. Money includes :
 - a. Currencies and demand deposits.
 - b. Bonds, government securities.
 - c. Equity shares.
 - d. All of the above.

3. Which of the following statements about money is incorrect?
 - a. There are many assets which carry the attribute on money.
 - b. Money is what money does.
 - c. In modern sense, money has stability, high degree of substitutability and feasibility of measuring statistical variation.
 - d. None of the above.

4. M_1 in the money stock in India refers to :
 - a. Post office saving deposits.
 - b. Total post office deposits.
 - c. Currency plus demand deposits plus other deposits with RBI.
 - d. Time deposits with banks.

5. Narrow money refers to
 - a. M_1
 - b. M_2
 - c. M_3
 - d. M_4

6. Broad money refers to
- M_1
 - M_2
 - M_3
 - M_4
7. The basic distinction between narrow and broad monies is the
- Treatment of post office deposits.
 - Treatment of time deposits of banks.
 - Treatment of savings deposits of banks.
 - Treatment of currency.
8. According to the RBI's Third working Group, NM_2 + Long Term Term Deposits with Banks with maturity over one year + Call/Term borrowing of the banking system is equal to
- NM_1
 - NM_2
 - NM_3
 - NM_4
9. Which of the following statements about banks is incorrect?
- Banks encourage saving habits among people.
 - Banks mobilise savings and make them available for production.
 - Banks help in creating credit money.
 - None of the above.
10. Banks perform the function of
- Receiving deposits
 - Lending of money
 - Agency services
 - All of the above.



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11. Commercial banks in India were nationalised in 1969 because
- There was urban bias.
 - Agriculture sector was neglected.
 - There was concentration of economic power.
 - All of the above.
12. Nationalisation of banks aimed at all of the following except
- Removal of control by a few.
 - Provision of credit to big industries only.
 - Provision of adequate credit for agriculture, small industry and export units.
 - Encouragement of a new class of entrepreneur.
13. Rural bank branches constitute _____ per cent of total bank branches in India.
- 14
 - 60
 - 38
 - 82
14. Population per bank in India is
- Around 5000
 - Around 20000
 - Around 12000
 - Around 45000
15. In terms of deposit mobilisation, _____ leads other states.
- U.P.
 - Maharashtra
 - Kerala
 - Bihar

16. In terms of lending, priority sectors constitute about _____ of total bank lending.
- a. 60
 - b. 80
 - c. 30
 - d. 36
17. Which is the Central Bank of India?
- a. State Bank of India.
 - b. Punjab and National Bank.
 - c. Oriental Bank of Commerce.
 - d. Reserve Bank of India.
18. Commercial banks suffer from
- a. Regional imbalances.
 - b. Increasing overdues.
 - c. Low efficiency.
 - d. All of the above.
19. Who is the official “lender of the last resort” in India?
- a. SBI
 - b. PNB
 - c. RBI
 - d. OBC
20. _____ refers to that portion of total deposits of a commercial bank which it has to keep with RBI in the form of cash reserves.
- a. CRR
 - b. SLR
 - c. Bank Rate
 - d. Repo Rate`



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21. _____ refers to that portion of total deposits of a commercial bank which it has to keep with itself in the form of liquid assets.
- CRR
 - SLR
 - Bank Rate
 - Repo Rate
22. CRR in September, 2014 was _____ per cent.
- 8
 - 6
 - 4
 - 5.5
23. At present, SLR is _____ per cent. (September, 2014)
- 22
 - 30
 - 35
 - 40
24. _____ is the official minimum rate at which the Central Bank of a country is prepared to rediscount approved bills held by banks.
- CRR
 - SLR
 - Bank Rate
 - Repo Rate
25. At present, Bank rate is _____ per cent. (September, 2014)
- 5
 - 9
 - 6.5
 - 5.5

26. In order to control credit in the country, the RBI may
- Buy securities in the open market.
 - Sell securities in the open market.
 - Reduce CRR.
 - Reduce Bank Rate.
27. In order to encourage investment in the country, the RBI may
- Reduce CRR.
 - Increase CRR.
 - Sell securities in the open market.
 - Increase Bank Rate.
28. In order to discourage investment in the economy, the RBI may
- Increase Bank Rate.
 - Decrease Bank Rate.
 - Buy securities in the open market.
 - Decrease CRR.
29. The effect of increase CRR will be reduced or nullified if :
- Bank rate is reduced.
 - Securities are sold in the open market.
 - SLR is increased.
 - People do not borrow from non-banking institutions.
30. In order to control credit
- CRR should be increased and Bank Rate should be decreased.
 - CRR should be reduced and Bank Rate should be reduced.
 - CRR should be increased and Bank Rate should be increased.
 - CRR should be reduced and Bank Rate should be increased.



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31. _____ controls affect indiscriminately all sectors of the economy.
- Selective credit.
 - Quantitative.
 - Margin requirements.
 - None of the above.
32. During depression, it is advisable to
- Lower Bank Rate and purchase securities in the market.
 - Increase Bank Rate and purchase securities in the open market.
 - Decrease Bank Rate and sell securities in the open market
 - Increase Bank Rate and sell securities in the open market.
33. Which of the following statements is correct?
- The RBI is just like any ordinary commercial bank in India.
 - The RBI is responsible for the overall monetary policy in India.
 - Selective credit control measures affect all banks in a similar manner.
 - A high rate of interest encourages new investment.
34. 'The lender of last resort' means
- The government coming to the rescue of poor farmers.
 - Central Bank coming to the rescue of other banks in times of financial crisis.
 - Commercial banks coming to the rescue of small industrial units.
 - None of the above.
35. Who is the custodian of monetary reserves in India?
- SBI
 - SIDBI
 - NABARD
 - RBI

36. Who is called the 'bank of issue'?
- a. RBI
 - b. SBI
 - c. IDBI
 - d. ICICI
37. Who is the fiscal agent and adviser to government in monetary and financial matters in India?
- a. SBI
 - b. IDBI
 - c. ICICI
 - d. RBI
38. Who is the custodian of national reserves of international currency?
- a. SBI
 - b. IDBI
 - c. RBI
 - d. ICICI
39. The profitability ratio of bank has declined over the years due to
- a. Lower interest on government borrowings from banks.
 - b. Subsidisation of credit to priority sector.
 - c. High expenditure resulting from overstaffing and mushrooming of branches.
 - d. All of the above.
40. Which of the following statements is correct?
- a. Rural areas have nearly 38 per cent of bank branches but *more than 70* per cent of the population residing there.
 - b. Banks are evenly spread out.
 - c. Most of the banks have *almost nil NPAs*.
 - d. None of the above.



ANSWERS

1.	c	2.	d	3.	d	4.	c	5.	a	6.	c
7.	b	8.	c	9.	d	10.	d	11.	d	12.	b
13.	c	14.	c	15.	b	16.	d	17.	d	18.	d
19.	c	20.	a	21.	b	22.	c	23.	a	24.	c
25.	b	26.	b	27.	a	28.	a	29.	a	30.	c
31.	b	32.	a	33.	b	34.	b	35.	d	36.	a
37.	d	38.	c	39.	d	40.	a				

