MONEY & BANKING
PART-4
TOPIC – RBI AS A CONTROLLER OF CREDIT

Central bank or RBI plays an important role during the times of economic fluctuations. It influences the money supply through:

1. Quantitative instruments:
Bank Rate;
Repo Rate;
Reverse Repo Rate;
Legal Reserve ratios;
Cash reserve Ratio;
Statutory Liquidity ratio; and
Open Market Operations;

2. Qualitative instruments:
Moral Suasion;
Credit Rationing;
Direct Action; and
Margin Requirement.

Now we will discuss in detail about how Central Bank (RBI) is using these instruments to control credit in an economy (India).

QUANTITATIVE INSTRUMENTS

1. BANK RATE POLICY - It refers to the rate at which the central bank lends money to commercial banks as a lender of the last resort for long term requirements.
Central Bank increases the bank rate during inflation (excess demand) and reduces the same in times of deflation (deficient demand).

2. REPO RATE POLICY - It refers to the rate at which the central bank lends money to commercial banks as a lender of the last resort for short term requirements.
Central Bank increases the Repo rate during inflation (excess demand) and reduces the same in times of deflation (deficient demand).

3. REVERSE REPO RATE – It is the rate at which RBI borrows money from the commercial banks or RBI accepts excess deposits of commercial banks.

Central Bank increases the Reverse Repo rate during inflation (excess money supplies exist in an economy) and reduces the same in times of deflation (excess money supplies exist in an economy).

4. LEGAL RESERVE RATIO - LRR (Legal Reserve Ratio) refers to that legal minimum fraction of deposits which the banks are mandate to keep as cash with themselves. The LRR is fixed by the Central Bank. It has two components: Cash Reserve Ratio and Statutory Liquidity Ratio.

(i) Cash Reserve Ratio (CRR) - It refers to the minimum percentage of net demand and time liabilities to be kept by commercial banks with central bank.

(ii) Statutory Liquidity Ratio (SLR) - It refers to minimum percentage of net demand and time liabilities which commercial banks required to maintain with themselves in the form of specified liquid assets including cash, gold and govt. securities.

R.B.I. can influence the credit creation power of commercial banks by making changes in CRR and SLR. Reserve Bank increases CRR during inflation to reduce credit and decreases the same during deflation to increase credit. SLR is also increased during inflation to reduce credit and decreased during deflation to increase credit.

6. OPEN MARKET OPERATIONS - It refers to the buying and selling of securities by the Central Bank from/ to the public and commercial banks. It sells government securities during inflation to control credit and buys the securities during deflation to increase money supply and credit in economy.

MONETARY POLICY (ADOPTED BY RBI)		
	QUANTITATIVE MEASUREMENTS	
Inflation		**Deflation**
Increase	**BANK RATE**	Decrease
Increase	**REPO RATE**	Decrease
Increase	**REVERSE RAPO RATE**	Decrease
Increase	**CASH RESERVE RATIO**	Decrease
Increase	**S. L. R.**	Decrease
Sell of Securities	**OPEN MARKET OPERATION**	Purchase of Securities

QUALITATIVE INSTRUMENTS

1. MARGIN REQUIREMENTS - It is the difference between the amount of loan and market value of the security offered by the borrower against the loan. Margin requirements are increased during inflation to restrict credit and decreased during deflation to encourage credit.

2. MORAL SUASION - It is a combination of persuasion and pressure that Central Bank applies on other banks in order to get them act in a manner in line with its policy.

3. SELECTIVE CREDIT CONTROLS - central bank gives direction to other banks to give or not to give credit for certain purposes to particular sectors.

4. DIRECT ACTION - Central Bank can take direct action against the banks who are not following the circulars and instructions given by the RBI. Under this tool RBI can stop functioning as banker's bank i.e. lender of last resort, clearing house function, accepting deposits etc.

MONETARY POLICY (ADOPTED BY RBI)		
QUALITATIVE MEASUREMETS		
Inflation		Deflation
Increase	**MARGIN REQUIRMENTS**	Decrease
Follow by Commercial banks	**MORAL SUASSION**	Follow by Commercial banks
Selected Credits	**CREDIT RATIONING**	Encourage Credits
Stop functioning as banker's bank	**DIRECT ACTION**	Stop functioning as banker's bank