MONEY & BANKING
PART-3

TOPIC – FUNCTIONS OF CENTRAL BANK

A central bank plays an important role in monetary and banking system of a country. It is responsible for maintaining financial sovereignty and economic stability of a country, especially in underdeveloped countries.

"A Central Bank is the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in that country"-Bank of International Settlement.

It issues currency, regulates money supply, and controls different interest rates in a country. Apart from this, the central bank controls and regulates the activities of all commercial banks in a country.

The central bank does not deal with the general public directly. It performs its functions with the help of commercial banks. The central bank is accountable for protecting the financial stability and economic development of a country. Apart from this, the central bank also plays a significant part in avoiding the cyclical fluctuations by controlling money supply in the market. The functions of central bank are broadly divided into two parts, namely, **traditional functions** and **developmental functions**.

(A) TRADITIONAL FUNCTIONS: Refer to functions that are common to all central banks in the world. The traditional functions of the central bank include the following:

1. CURRENCY AUTHORITY OR BANK OF NOTE ISSUE -

Central bank is a sole authority to issue currency in the country. The main advantages of sole authority of note issue are -

(a)Uniformity in note circulation,
(b) Better supervision and control,
(c) It is easy to control credit,
(d) Ensure public faith,
(e) Stabilization in internal and external value of currency.

2. BANKER'S BANK-

RBI acts as Bankers bank in 3 capacities-

Banker's Bank and Supervisor – There are no of commercial bank in country. There should be some agency top regulate and supervise their proper functioning. Being the apex bank, The RBI regulates and controls the commercial banks. The regulation of banks may be related to their licensing, branch expansion, liquidity of assets, management. Merging, winding up etc. The control is exercised by periodic inspections of banks and the returns filed by them.

Custodian of Cash Reserve – Commercial Banks must keep a certain proportion of cash reserves with the central banks from their total Deposit (known as Cash Reserve Ratio or CRR).

Lender of Last Resort - The central bank also acts as lender of last resort for the other banks of the country. It means that if a commercial bank fails to get financial accommodation from anywhere, it approaches the central bank as a last resort. Central bank advances loan to such a bank against approved securities. As a lender of the last resort, central bank exercises control over the entire banking system of the country.

3. BANKER TO THE GOVERNMENT –

The central bank act as a banker, an agent and a financial advisor to the central government and all the state governments.

Banker to the Government – As a Banker - to the govt., it acts like commercial bank to the public. Accepts receipts & makes payment for the govt. It provides short term credit to the govt. It provides foreign exchange resources to the govt. to repay external debt. It manages public debt. It advises the govt. on banking & financial matters.

As an Agent – The central bank also has the responsibility of managing the public debt and collect taxes.

As a financial Advisor – The central bank advises the government from time to time on economic, financial and monetary matters.

4. CUSTODIAN OF FOREIGN EXCHANGE RESERVES –

Another important function of Central Bank is the custodian of foreign exchange reserves. Central Bank acts as custodian of country's stock of gold and foreign exchange reserves. It helps in stabilizing the external value of money and maintaining favorable balance of payments in the economy.

5. CLEARING HOUSE –

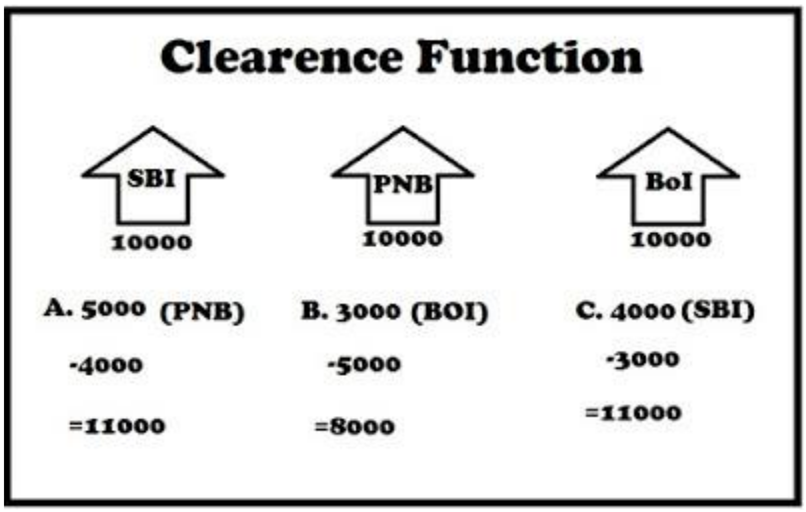
Every bank keeps cash reserves with the central bank. The claims of banks against one another can be easily and conveniently settled by simple transfers from in to their account. Supposing –

- Bank A (SBI) receives a cheque of Rs 5,000 drawn on Bank B (PNB),
- Bank B (PNB) receives a cheque of Rs. 3000 drawn on Bank C (BOI) and
- Bank C (CBI) receives a cheque of Rs 4,000 drawn on Bank a (SBI).

The most convenient method of settling or clearing their mutual claims is that-

- Bank A (SBI) should issue a cheque amounting to Rs 4000 in favour of Bank C (CBI),
- Bank B (PNB) should issue a cheque amounting to Rs 5000 in favour of Bank A (SBI) and
- Bank C (CBI) should issue a cheque amounting to Rs 3000 in favour of Bank B (PNB), drawn on central Bank.

As a result of this transference, a sum of Rs 5000 will be debited to the account of Bank A and credited to the account of B. There is no need of cash transactions between the banks concerned. It facilitates cash transaction across the entire banking system, it also reduces requirement of cash reserves of the commercial banks.



<u>6. CONTROLLER OF MONEY SUPPLY AND CREDIT –</u>

Central bank or RBI plays an important role during the times of economic fluctuations. It influences the money supply Through Quantitative instruments (like – Bank Rate, Open Market Operations, legal Reserve ratios, Cash reserve Ratios, Statutory Liquidity ratios) and Qualitative instruments (like – Moral Suasion, Credit Rationing, Direct Action, Margin Requirements).

<u>(B) DEVELOPMENTAL FUNCTIONS:</u> Refer to the functions that are related to the promotion of banking system and economic development of the country. These are not compulsory functions of the central bank. These are discussed as follows:

<u>(1) DEVELOPING SPECIALIZED FINANCIAL INSTITUTIONS:</u>

Refer to the primary functions of the central bank for the economic development of a country. The central bank establishes institutions that serve credit requirements of the agriculture sector and other rural businesses.

Some of these financial institutions include Industrial Development Bank of India (IDBI) and National Bank for Agriculture and Rural Development (NABARD). These are called specialized institutions as they serve the specific sectors of the economy.

(2) INFLUENCING MONEY MARKET AND CAPITAL MARKET:

Implies that central bank helps in controlling the financial markets Money market deals in short term credit and capital market deals in long term credit. The central bank maintains the country's economic growth by controlling the activities of these markets.

(3) COLLECTING STATISTICAL DATA:

Gathers and analyzes data related to banking, currency, and foreign exchanges position of a country. The data is quite helpful for researchers, policymakers, and economists. For instance, the Reserve Bank of India publishes a magazine called Reserve Bank of India Bulletin, whose data is useful for formulating different policies and making macro-level decisions.