Chapter 5 Banking

Meaning of Commercial Bank- These banks are regulated by banking regulation act 1949. They accept the public deposit from the public for the purpose of lending and earning a decent amount of profits by lending money. These banks also helps to mobilize the savings of an individual, making funds accessible to business and help them to start a new venture

MONEY CREATION/DEPOSIT CREATION/CREDIT CREATION BY COMMERCIAL BANK

Let us understand the process of credit creation with the following example.
Suppose there is an initial deposit of Rs. 1000 and L.R.R. is 20% i.e., the banks have to keep Rs. 200 and lend Rs. 800/-. All the transactions are routed through banks. The borrower withdraws his Rs. 800/- for making payments which are routed through banks in the form of deposits account. The Bank receives Rs. 800/- as deposit and keeps 20% of Rs.800/- i.e., Rs.160/- and lends Rs.640/- . Again the borrower uses this for payment which flows back into the banks thereby increasing the flow of deposits.

	Deposits (in Rs.)	Loans (in Rs.)	Cash Reserve Ratio (20%)
Initial deposit	1000	800	200
First round	800	640	160
Second round	640	512	128
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
Total	5000	4000	1000

MONEY MULTIPLIER

Money Multiplier = 1/LRR. In the above example LRR is 20% i.e., 0.2, so money multiplier is equal to 1/0.2=5.
Commercial banks keep only afraction of deposits is kept as Cash Reserve because by their past experience they know that :-
a) All depositors do not withdraw the money at the same time.
b) There is constant flow of new deposits into the banks.

CENTRAL BANK

MEANING

An apex body/ institution of a country's monetary system. that controls, operates, regulates and directs the entire banking and monetary structure of the country.India's central bank is the Reserve Bank of India.

FUNCTIONS OF CENTRAL BANK

1) Currency authority or bank of issue: Central bank is a sole authority to issue currency in the country. All the currency issued by the central bank is its monetary liability. This means that RBI is obliged to back the currency with assets of equal value (usually gold coins, gold bullions, foreign securities etc.,) Advantages of sole authority of note issue:
a) Uniformity in note circulation
b) Better supervision and control
c) It is easy to control credit
d) Ensures public faith
e) Stabilization of internal and external value of currency.
2) Banker to the Government: As a banker it carries out all banking business of the Government and maintains current account for keeping cash balances of the government. Accepts receipts and makes payments for the government. It also gives loans and Advances to the government.
3) **Banker's bank and supervisor**: Acts as a banker to other banks in the country, As the banker to banks , the Central Bank holds a part of the cash reserves of banks, lends them short term funds and provides them with centralized clearing and remittance facilities.
4) Controller of Money Supply and Credit :- The Central Bank controls the money supply and credit in the best interests of the economy by various instruments as quantitative and qualitative instruments.
5) Custodian of cash reserves:- Commercial banks must keep a certain proportion of cash reserves with the central bank (CRR)
6) Lender of last resort: – When commercial banks fail to need their financial requirements from other sources, they approach Central Bank which gives loans and advances.
7) Clearing house: – Since the Central Bank holds the cash reserves of commercial banks it is easier and more convenient to act as clearing house of commercial banks.
8) Controller of money supply and credit: – Central Bank or RBI plays an important role during the times of economic fluctuations. It influences the money supply through quantitative and qualitative instruments. Former refers to the volume of credit and the latter refers to regulate the direction of credit or investment.
9) 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.

Methods/Instruments of credit control applied by RBI:-

QUANTITATIVE INSTRUMENTS

i) 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 to commercial banks against approved securities or eligible bills of exchange. Central Bank increases the bank rate during inflation (excess demand) and reduces the same in times of deflation (deficient demand)
ii) 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/excess demand and buys the securities during deflation/deficient demand.
iii) Varying Reserve Requirements :- Banks are obliged to maintain reserves with the central bank on two accounts. One is the cash reserve ratio and the other is Statutory Liquidity Ratio. Varying CRR and SLR are tools of monetary and credit control. R.B.I. can influence the credit creation power of commercial banks by making changes in CRR and SLR which are explained below:-

a)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. Reserve Bank increases CRR during inflation and decreases the same during
deflation.
b)Statutory Liquidity Ratio (SLR): It refers to minimum percentage of net demand and time liabilities which commercial banks required to maintain with themselves. SLR is increased during inflation or excess demand and decreased during deflation or deficient demand.

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 and decreased during deflation.
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. These can be applied in both a positive as well as a negative manner.
