

## Nature of Central Bank

- ▶ It is most powerful economic institutions that has been developed to help society to manage its collective financial affairs.
- ▶ The activities of the central bank regarded essential for the proper functioning of the economy.
- ▶ Almost all the central banks were started as private owned banks and concerned about profits and so, they competed with commercial banks.
- ▶ The central banks have crystallised into a distinct entity of their own.

# Functions of Central Bank

## Issue and Regulation of Currency

- ▶ One of the most important functions of a central bank is the issue and regulation of currency.
- ▶ It everywhere enjoys the monopoly of note issue.
- ▶ The central banks are vested with the monopoly of the note issue for the following reasons.
  - a) To insure uniformity in the note issue which will facilitate trade and exchange within the country.
  - b) To imprint the notes with a distinct prestige.
  - c) To restrict or expand the supply of notes according to the requirements of the economy.
  - d) To bring stability in the monetary standard and create confidence among the public.
  - e) To influence and control credit creation by commercial banks.

The following are different methods of note issue.

**1. Partial fiduciary system –**

- a. Under this system, a fixed amount laid down by law need to be covered by gold without affecting convertibility of notes.
- b. The system has been criticized on the ground that it facilitates inflation and exposes the currency to the danger of monetary instability.

### **3. Proportional reserve system–**

- a. Under this system, a certain percentage of note issue should be backed by gold reserve.
- b. The remaining amount of note issue should be covered by government securities.
- c. This system was first introduced in Germany.
- d. Later was adopted in USA in 1913.
- e. India followed this system between 1935 and 1956.
- f. This system had the advantage of elasticity.
- g. The supply of money can be increased easily to meet the demands of the country.
- h. The system provides adequate security as a certain percentage of note issue is covered by gold. So, it creates confidence in the public.

#### **4. Minimum reserve system–**

- a. Under this, the central bank is required to maintain a minimum reserve of gold or foreign securities or both.
- b. No maximum limit is placed on the amount of note issue.
- c. The central bank can issue notes according to the needs of the country.

## 2. Banker, Agent and Adviser to the Government

- ▶ The central bank acts as banker, agent and adviser to the government.
- ▶ As a banker to the government, the central bank receives deposits and makes payments on behalf of the government.
- ▶ It buys and sells foreign currencies on behalf of the government.
- ▶ As an agent, the central bank makes short-term loans to the government for a period not exceeding 90 days.
- ▶ It undertakes the issue of new loans and treasury bills, redeems old securities and renews them according to market conditions.

### **3. Banker's Bank–**

The central bank acts as a banker's bank in different capacities.

- a. Custodian of cash reserve of commercial banks.
- b. Lender
- c. Bank of central clearance, settlement and transfer.

#### **4. Custodian of Foreign Exchange Reserves.**

- a. The central bank keeps and manages the foreign exchange reserves of the country.
- b. Funds coming from and going out to foreign countries are channeled through the central bank.
- c. All the incomes in foreign currencies accrued to the central bank to go the foreign exchange accounts and payments are met from these accounts.
- d. All the balances are kept under the custody of bank.
- e. Further, the central banks in most countries maintain both gold and foreign currencies as reserves against note issue and also meet adverse balance of payments.



## **5. Controller of Credit**

## **6. Research and Data Collection**

- a. In addition to above functions, a modern central bank collects and publishes important monetary data pertaining to the working of the banking system and the economy as a whole.
- b. It helps to understand the nature and magnitude of problems facing the economy and seeks the solutions thereof.

### **Methods of Credit Control:–**

1. The most function of central bank is to control credit created by commercial bank.
2. Money and credit represent a powerful force for good or evil in the economy.
3. Money cannot manage itself. So, it is the duty of the central bank to ensure that money and credit is properly managed so that inflationary and deflationary pressures can be controlled in the economy.
4. In modern times, bank credit has become the important source of money and commercial banks have unlimited power to expand or contract credit.
5. A central bank has a number of weapons to control credit created by commercial banks.

Methods of credit control are broadly divided into two:-

1. Quantitative credit control methods.
2. Qualitative or selective credit control methods.

**1. Quantitative credit control methods.**

- a. This methods aims to control the total quantity of cost of credit created by banks.
- b. This method is traditional and indirect.

This includes-

- i. Bank rate policy
- ii. Open market operations.
- iii. Variable reserve ratio

## **2. Qualitative or selective credit control methods:-**

- i. Qualitative methods control the use and direction of credit.
- ii. These controls are direct, which consist of –
  - a) Regulation of consumer credit
  - b) Margin requirements
  - c) Rationing of credit
  - d) Direct action
  - e) Moral suasion
  - f) Publicity.