4 Banking and Monetary Policy

- Introduction
- 4.1 Evolution and Meaning of Banks
- 4.2 Classification of Banks (Major Types)
  - 4.2.1 Commercial Bank
    - 4.2.1.1 Functions of Commercial Banks
    - 4.2.1.2 Presence of Commercial Banks in India
  - 4.2.2 Central Bank
    - 4.2.2.1 Reserve Bank of India (RBI)
    - 4.2.2.2 Functions of Reserve Bank of India
- 4.3 Monetary Policy
  - 4.3.1 Instruments of Monetary Policy

Introduction

All of us may be aware of the word bank. We may have deposited our domestic savings in some bank/s in the form of term deposits or savings deposits. Parents of many of us may have opened an account in some bank for business transactions and some parents might be receiving LPG subsidy in their bank accounts.

Besides, we may have paid our school fees by way of a cheque of some bank, and may have withdrawn money from a bank to buy TV, refrigerator etc. Parents of some of us may have borrowed money as a loan from a bank to purchase a house. Thus, in modern times most of our monetary transactions take place through banks, thus in this chapter we will get some idea about banks.

4.1 Evolution and Meaning of Banks

In English language, the word bank means 'heap' or 'mass'. In Sanskrit language, the word akin to bank is 'bhanda' which means collection of capital/fund. The word 'bhandod' is derived from 'bhanda'. The English word bank originated from the Italian word 'banca' or from the French word 'banque'. Both these words meant a 'Bench' for money exchange. In olden days, European money lenders or money changers used to display coins of different countries in big heaps on benches or tables for the purpose of lending or exchanging. Thus, they were exchangers of various coins (currencies of various regions). Thus the word 'bank' came into use.

It can be concluded that the word bank is related to collection/fund of money.

The 'Bank of Barcelona' set up in Spain in 1401 is known to be the first real bank established in the world. With the introduction of currency money, people started using money not only as a measuring rod of value, unit of account or medium of exchange; but also as a store of value and standard of deferred payments. With furthering in the functions of money, there arose a need to maintain the value of money. In short, in economic systems dependent on money, there arose the need for an institutional arrangement for safety of money, transfer of money and maintaining the value of money; and the role of such an institution is played by banks.

Meaning of a Bank : A bank is that institution which provides services of banking That is,

- A bank is an institution authorised to collect peoples' savings/deposits with the purpose of lending those; under the condition of returning the same when the depositor demands.
- A bank is a commercial organization functioning for profit which accepts peoples' savings

in the form of deposits and pays interest in return, it ensures the safety of these deposits, lends money from these deposits to people who need money by charging them with interest; and invests the surplus funds in various sectors for development of the nation.

To state briefly, banks are instrumental in mobilizing money. Value of stock of money which is not mobilized among activities tends to fall at a future date. Value of circulating money tends to increase.

4.2 Classification of Banks (Main Types)

Banks are broadly classified in two categories : (1) Commercial bank (2) Central bank

4.2.1 Commercial Bank

According to the Banking Company Act, (1949)

"Commercial bank is one which transacts the business of banking, that is, accepting deposits from the people for the purpose of lending or investment; repayable on demand or otherwise and withdrawable by cheque, draft, pay-order or otherwise."

A commercial bank is a business unit which provides banking services for profit.

People entrust their savings with the banks which banks handle in the form of deposits. Banks also use some of these deposits for other economic activities and therefore they give interest to the depositors.

Banks may use deposits for investment in the agricultural and industrial sectors for their development or they may buy government securities or they may lend some proportion of the deposits to people who need money. When banks invest some of the deposits, they earn profit and when they lend this money, they earn by charging interest.

The lending rate of interest is higher than the rate of interest which banks give on deposits and the difference between the two is the profit earning. Hence, banks are called commercial institutions.

In other words, banks undertake activity of mobilizing peoples' money in order to make profit and therefore they are commercial institutions.

4.2.1.1 Functions of Commercial Banks

Commercial banks perform several functions which are as under :

(A) Primary Functions :

(1) Accepting Deposits : A bank accepts money from the people (savers) in the form of deposits. It gives safety to the deposits of its customers by acting as a custodian of funds. In a way people lend their savings to banks for which banks give them interest.

Deposits are mainly of three types :

(1) Current Account Deposits : A current account is opened with a bank in the name of a business, firm or an individual. The deposits in this account are more liquid than deposits in any other account. Withdrawal can be made from this account any number of times during a day. The customers of this account are given a cheque book but do not get interest on current account deposits, on the contrary certain times banks may impose some kind of service charges on this account. A customer may even obtain overdraft facility for business purpose on this account as per rules of the bank.

(2) Savings Account Deposits : People usually deposit savings for a short period in this account for which banks give them interest. Upon requirement, they can withdraw with a cheque or withdrawal slip. In present times they can also withdraw money from this account by using debit card or credit card.

Facility of Recurring Account (Recurring Deposit) : These deposits are also a type of savings deposits. People who do not wish to save or cannot save bigger sums of money, save and deposit small amounts each month for some period of time in this account. Thus, the savings gradually increase and interest is paid on the accumulated money. Thus, these deposits are called recurring depostis. (By rules of some banks, if a person skips to deposit some month's money in this account, she/he may have to pay a penalty along with some interest loss.)

- **Fixed/Long Term Deposits :** These deposits are for a fixed period of time and usually people who want to deposit money for a long period of time choose such deposits. Banks pay highest rate of interest on such deposits among all types of deposits. Customers get overdraft facilities on such deposits.

(2) Providing Credit Facilities : When individuals or businesses require money for personal or investment purposes, they borrow from banks and banks provide credit by charging a rate of interest. In terms of time period, borrowing/credit can be for short term, medium term or long term. (These time periods are not strictly fixed and may vary for different activities. However, in a theoretical sense, short term is a period up to 1 year; medium term is a period between 1 and 5 years and long term is a period between 5 and 15 years.)

In the context of purpose, credit can be for personal reasons, for agricultural activity or for business activity.

The rates of interest charged vary with purpose.

(3) Payment and Withdrawal Facilities : A bank provides easy payment and withdrawal facility to its customers in the form of cheques, withdrawal slips and drafts, pay order, ATM facilities, (Automatic Teller Machines), credit and debit cards, internet banking, etc.

(4) Credit Creation : Banks undertake the activity of credit creation to ensure that the supply of money in the economy fulfils the demand for money. Banks create money from the existing stock of money (deposits); thereby add to the supply of money in the economy. When credit creation by banks increases, the supply of money increases and when credit creation decreases, the supply of money reduces.

When a bank lends money from primary deposits, the borrower has to open an account with the same bank or another branch in order to deposit the cheque of the loan (borrowed sum of money). When the cheque is credited in the new account, it becomes a derived deposit for the bank. From this derived deposit, the bank can create still another loan account for a third person. The third person's loan becomes one more deposit for the bank. Thus, a bank can create several deposits from a primary deposit.

Besides, when the borrower withdraws the loan amount from her/his account and spends it, there is greater circulation/supply of money in the economy.

No bank can lend the full amount of a deposit. From every deposit, the bank has to keep aside some proportion of money in the form of cash reserves which is known as cash reserve ratio. Thus they can lend the remaining money only.

If a bank has a primary deposit of ₹ 1,000 and the cash reserve ratio determined by rule is 20% then the bank can create credit up to ₹ 1,000 × $\frac{1}{20\%}$. In other words, primary deposit of ₹ 1,000 can create a money supply of ₹ 5,000 and it can be said that new credit of ₹ 4,000 is created. This can be understood with an example,

Table 4.1

Bank **(1)**	**Net Deposits** **(in ₹)** **(2)**	**Required Reserves** **(in ₹) Reserve ratio 20 %** **(3)**	**New Loans** **(in ₹)** **(4)**
A	**1,000**	200	800
B	800	160	640
C	640	128	512
.	.	.	.
.	.	.	.
.	.	.	.
Total	5,000	**1,000**	4,000

This, credit creation = Primary deposit × $\frac{1}{\text{cash reserve ratio}}$

When customers withdraw more money than the deposited amount from their current account it is called over draft facility and this also leads to credit creation.

(5) Inter-Banking Transactions : Banks provide short term and long term credit to one another from time to time. Short term credit is provided by one bank to another through the central bank and is called 'call money'. The interest rate on call money is called the 'call money rate'.

(B) Secondary/Other Functions of Commercial Banks :

Banks also perform certain other functions as,

(1) Agency and Utility Services : A bank provides various utility and agent banking facilities to its customers. For example, a bank can act as a mediating agent by providing a letter of credit to the exporter on behalf of the importer. Banks also provide underwriting services to various businesses.

Banks also provide facilities to its customers to pay tax challans. Banks also provide safe deposit vaults on rent to its customers, wherein they can safely store their precious jewellery, documents etc.

Banks provide micro finance facilities for very small businesses which are important for development of communities. When some payments are to be made with full proof security, banks provide service to the payer by issuing draft or pay order.

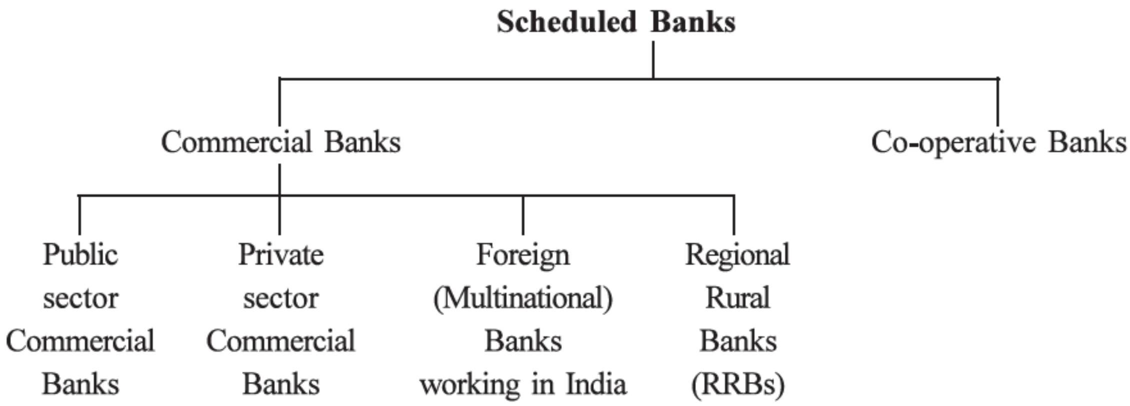
(2) Provide various Facilities with Changing Times : Banking is an evolutionary concept. There is continuous expansion and diversification of the functions, activities and services of the banks. In present times, electronic transfer of money from the account of one customer to that of any other customer of any bank (without using cash or cheque) is done through facilities like NEFT (National Electronic Fund Transfer) and RTGS (Real Time Gross Settlement). Both these are possible because of CORE banking. (Centralized Online Real Time Exchange)

Besides, customers can get various details of their account as well as make payments, buy goods, book tickets etc. on their computer or mobile phone through internet banking and mobile banking app. Banks also provide safe deposit vaults and facilities of DEMAT account. (Dematerialized account). This is an account where shares, debentures, bonds etc. can be held in electronic form which is easier than holding them in physical form.

4.2.1.2 Presence of Commercial Banks in India :

Commercial banks in India operate in the public as well as private sectors. After the economic reforms of 1991, foreign banks have entered the private sector. Besides, there are financial companies which function like banks in the unorganized and organized money markets of India. And, there also is the existence of co-operative banks.

But, by the official definition of banks in India, only those companies which are listed in the 2nd schedule of the RBI Act, 1934 (are established accordingly) are called scheduled banks and are the real banks. All rules and regulations of the Reserve Bank of India, apply to these banks.



The above chart gives a classification of scheduled banks.

4.2.2 Central Bank :

There exists a central bank in all countries of the world, which manages, evaluates and regulates the banking activities in the entire country. Besides, a central bank protects the interests and rights of customers of various banks and of the general public.

R. P. Kent defines a central bank as, "The institution charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of the general public welfare".

Hence, central bank is the Apex bank of the country whose function is to aid, regulate and promote the entire money market and the banking sector; as well as to maintain monetary/financial stability for overall economic good of the nation.

Mobilization of money has several macroeconomic implications which impact economic growth and development of a nation. The responsibility of regulating monetary/financial transactions in a country and maintaining the value of the country's money/currency rests with the central bank. In order to fulfil this responsibility, a central bank formulates a monetary policy. In short, a central bank assumes the responsibility of maintaining economic stability.

A central bank also provides monetary/financial advice and suggestions to the government.

4.2.2.1 Reserve Bank of India (RBI)

The central bank in India is known as Reserve Bank of India.

Under the Reserve Bank of India Act of 1934, the Reserve Bank of India was established on April 1, 1935 with a private paid up capital of ₹ 5 crores. RBI was nationalized on January 1, 1949.

RBI is the Apex bank of India which supervises and regulates the entire banking sector as well as formulates the monetary policy of India.

4.2.2.2 Functions of Reserve Bank of India

As the Apex bank of India, the RBI performs functions as,

(A) Monetary Functions (Monetary Responsibilities) :

(1) Currency Issue : Reserve Bank of India has the sole right to issue notes of denominations starting from ₹ 2 and above. Currency note of ₹ 1 and all currency coins are issued by the finance ministry of Government of India but the distribution of one rupee notes and currency coins is done by the RBI as an agent of the Government of India.

(2) Banker to the Government : The RBI is a banker, advisor and agent of the central government and of all state governments. It manages government bonds, government accounts, currency coins and notes of ₹ 1, and also provides loans to the government.

(3) Bankers' Bank and Lender of Last Resort : The RBI is a banker and regulator of all the scheduled banks in the country. It manages the Cash Reserves of banks, determines the direction of credit as well as directs the credit policy and rate of interest for all banks. It is also the lender of last resort for the scheduled banks in case of emergency.

(4) Credit Control : The RBI controls the process of credit creation and money supply in the economy with the help of various tools of monetary policy.

(5) Custodian of Foreign Exchange Reserves : The RBI has the responsibility of maintaining the value of rupee vis-a-vis other currencies under the fixed exchange rate regime. Under free exchange rate system where exchange rate is determined by the market, RBI maintains the value of Indian currency by buying and selling foreign exchange in the open market as and when required.

The RBI is also the custodian of India's reserves of foreign currencies. It also administers foreign exchange reserves by checking the inflow or outflow of foreign exchange.

(B) Non-Monetary Functions of Reserve Bank of India :

(1) Regulatory and Supervisory Functions : RBI supervises the functioning of the entire financial and money markets which include branch expansion and methods of working of scheduled banks, working of non banking finance companies and of co-operative banks.

(2) Promotional Functions : Even today, there are many people in India who do not hold a bank account. They depend on unorganized money market for their credit needs, make business related payments in cash rather than by cheques owing to which it is difficult to know the exact value of transactions taking place in the country and it becomes difficult to ascertain the exact value of money or arrive at the actual figure of national income. Hence RBI tries to create banking awareness among people, encourages branch expansion in rural areas and promotes setting up of co-operative banks in the interest of the people. It makes efforts to get more and more people under the organized money market.

(3) Financial Inclusion and Development : India is a country with huge degree of economic diversity and rural-urban divide and hence whenever major economic reforms and changes come about it is necessary that people and economic units of all segments receive benefits of such changes. For such inclusion, RBI continuously makes efforts in the banking sphere. It provides special credit facilities to priority sectors like agriculture, small scale industries, self employed people, traditional and cottage industries etc.

It also makes efforts to increase information flow and enhance awareness regarding banking among the masses.

In the present times, RBI manages the Prime Minister's 'Jan Dhan Yojna'.

RBI also works towards protecting the interests and rights of customers.

It publishes all types of banking related information and statistics as well as experts' articles in order to promote research related to banking and monetary improvement in the country. On the RBI website people can get free access to such information.

4.3 Monetary Policy

In economic theory, monetary policy is the policy which regulates the demand for money and supply of money in the economy. It is essential to regulate these as an imbalance between demand for money and supply of money can result in inflation or deflation, can impact the value of Indian currency and destabilize the economy. Hence monetary policy is also known as one of the stabilization policies.

In earlier times, the purpose of monetary policy in India was more to regulate the volume of money, value of money and nature of money. In the present times, the monetary policy is used more for credit creation.

From the viewpoint of economic theory,\

- *Monetary policy constitutes the conscious steps undertaken by the monetary authority which bring about changes in the stock of money, source/generation of money, and cost of money.*

● *The policy which entrusts various tools of regulating supply of money in the hands of the apex bank with the purpose of achieving general economic objectives is called monetary policy.*

● *In simple terms, the policy undertaken by the apex bank for regulating the supply of money in order to maintain economic stability keeping into consideration the process of economic development and interest of the public is called monetary policy.*

4.3.1 Instruments of Monetary Policy :

The important instruments of monetary policy can be explained as,

(A) Quantative Measures (General Measures) : The quantative measures are aimed at impacting the entire economy in a general/common way and hence these are also called general measures.

(1) Bank Rate : When commercial banks have shortage of funds, they borrow from the RBI. The rate at which RBI lends to the commercial banks for long term is called the bank rate. If the bank rate is increased, commercial banks will borrow less as it is expensive to borrow. When they borrow lesser amounts and at higher rate, they give lesser amount of loans and at higher rate to the general public and when people get fewer loans, their demand for certain goods and services falls. On the whole, there is lesser creation of money, lower demand for goods and lower circulation of money in the economy. When the economy is under the grip of inflation, bank rate is increased to control inflation.

When supply of money is higher than demand for money there is inflation and hence reducing money supply helps in reducing inflation and if supply of money is lower than the demand for money, there is depression.

The policy of keeping the bank rate very low is called the cheap money policy and the policy of keeping the bank rate very high is called the dear money policy.

Table 4.2 Trends of Bank Rate in India

Year	Bank rate (in %)
1953	3.5
1981	10
1991	12
2016	7

Source : www.rbi.org

RBI has stopped using bank rate as an instrument to regulate money supply since last few years and is using repo rate, reverse repo rate instead. Bank rate is a rate for long term and hence cannot be changed in the very short period while, repo and reverse repo rates can be altered in very short periods also and thus they help to regulate money supply in the short term.

(2) Repo Rate and Reverse Repo Rate : When commercial banks need funds for very short period (sometimes for 1 day, 7 days, 15 days, etc.) they sell some securities which are held by them to RBI with a repurchase agreement at a particular rate. This rate is called the repo rate. (The word 'repo' is used for the term 'repurchase rate'.) Banks sell government securities to RBI in order to raise money for a very short term with a condition to repurchase them at some discount. Such a discounting rate is repurchase rate/repo rate.

In the event of inflation, central banks increase repo rate as this acts as a disincentive for banks to borrow from the central bank. Subsequently they lend to the general public at higher rate and ultimately people borrow less and thus money supply and inflation are arrested.

Reverse repo rate means the agreed upon rate at which the RBI repurchases its securities from the commercial banks in the event when the RBI has to borrow short term funds from the commercial banks by parking its securities with the commercial banks. (Even the RBI sells government securities held by it to commercial banks under the condition of repurchasing those at a discounted rate upon the end of the short term period.)

An increase in reverse repo rate means that commercial banks will get more incentives to park their funds with the RBI by lending more to RBI, thereby decreasing their lending to general public and ultimately reducing the supply of money in the market and vice-versa.

Table 4.3 Repo and Reverse Repo Rates in past few years

Year	Repo Rate (in %)	Reverse Repo Rate (in %)
January, 2006	6.50	5.50
March, 2010	5.0	3.50
April, 2016	6.5	6

Source : www.rbi.org

(3) Stabilization under Emergency Situation : There is a special window for banks to borrow from RBI against approved government securities in an emergency situation like an acute cash shortage. This rate is higher than Repo rate. In 2016, this rate was 7%. (This is called marginal standing facility.)

(4) Cash Reserve Ratio – CRR : Under the RBI Act, 1934, all commercial banks have to keep certain minimum cash reserves with the RBI. Initially CRR was decided to be 5% of demand deposits and 2% of time deposits. It was variable as per the requirement felt by RBI. Since 1962, CRR is variable between 3% and 15% of the total deposits of individual banks.

CRR fulfills the need of a comfortable amount of cash reserves with the banking system, in case many customers start withdrawing their deposits and banks have to provide cash against their deposits.

Besides, this is also used as an instrument to control inflation. When CRR is higher, commercial banks have lesser deposit money to create credit. Thus, they give fewer loans to people and hence money supply and inflation are curtailed. CRR is reduced in times of deflation and depression.

(5) Statutory Liquidity Ratio – SLR : Apart from and in addition to CRR, under the Banking Regulation Act, 1949, all banks have to maintain equal to and not less than 25% of their total deposits (demand and time deposits) in the form of cash, gold and unencumbered approved securities.

A higher SLR diverts bank funds from loans and advances to approved government securities and helps to meet government expenditures and on the other hand, it reduces the capacity of banks to create loans and raise money supply by credit creation and a lower SLR increases the capacity of banks to create loans and raise money supply by credit creation. If SLR is higher people get lesser credit and vice-versa.

(6) Open Market Operations – OMOs : Open market operations refer to sale of or purchase of government securities/bonds by the RBI in the open market.

When the RBI purchases government bonds from the market, the supply of money in the economy rises. The supply of money in the economy falls when RBI sells such bonds in the open market. Such operations are undertaken to regulate inflation and depression.

This instrument was not used in india prior to 1991.

(7) Sterilization of RBI accounts against shocks arising from excessive increase or decrease in amount of foreign exchange : When there is excessive inflow of foreign exchange in India owing to trade and foreign investment, the RBI indulges in open market sale of government securities equal to the amount of inflow of foreign exchange. This is done to keep its balance sheet unchanged owing to excessive foreign exchange. Thus, it sterilizes its balance sheet against external shocks. It buys government bonds if there is excessive outflow of foreign exchange.

(B) Selective (Qualitative) Measures of Credit Control :

Besides the general measures and different from the general measures the RBI uses certain selective measures to direct credit for development of certain sectors or sections of the economy;

These measures have unique impact on some sectors and are not meant to impact all sectors similarly. Some of these measures are,

(1) Security Requirement : Banks must ensure that public returns the loans given to them. Hence, they lend money against some security deposits from the borrowers. In case the borrower is not able to repay the loan, the bank uses the security to recover its dues. For example, a bank can take jewellery, deposits, car, house, land etc. as security.

Security specifications are different for different segments of the population so that all sections of the population can have the opportunity to obtain bank credit and all sectors including agricultural sector develop well. Hence RBI directs commercial banks regarding the amount of security which they may ask for in case of different types of loans or from different sections of the people. A poor farmer may be granted a loan without much security and a rich business person may be required to keep more as security with the bank for a loan.

(2) Margin Requirement : The RBI also sets margins for granting loans against security. An individual is given only a certain percentage as loan of the total value of assets offered as security. Banks are directed to selectively keep different margins for different purposes.

(3) Ceiling on Credit : The RBI also prescribes ceilings for credits for different purposes.

(4) Discriminatory Interest Rate : RBI suggests differential rates of interest for different types of lendings. This is called the policy of discriminatory interest rate. For example, a relatively lower rate of interest is charged from needy farmers than what is charged from rich business persons to buy a car or a house.

Exercise

1. Choose the correct option for the following questions :

(1) What is the meaning of the word 'bank' ?

(a) Money supply (b) Stock of money (c) Investment (d) Commerce

(2) How many major types of deposits exist in banks in India ?

(a) 2 (b) 6 (c) 10 (d) 3

(3) Short term lending in theoretical sense is for what period?

(a) Up to 1 year (b) 1 to 3 years (c) 1 to 5 years (d) 5 to 15 years

(4) What is a central bank ?

(a) A private bank (b) An apex bank

(c) A cooperative bank (d) A foreign bank

(5) What is the rate at which RBI borrows funds for very short term from the commercial banks is called?

(a) Repo rate (b) Bank rate

(c) Reverse repo rate (d) Open market rate

2. Answer the following questions in one line :

(1) Give the meaning of a bank.

(2) Give the meaning of a commercial bank.

(3) Give the meaning of a central bank.

(4) Give the meaning of monetary policy.

(5) What is meant by quantitative tools of monetary policy ?

(6) What is meant by qualitative tools of monetary policy ?

3. Answer the following questions in brief :

(1) How did the word 'bank' originate?

(2) Give an idea of the accounts of a commercial bank.

(3) Write a note on qualitative tools of monetary policy.

(4) Explain the functions of a central bank in short.

4. Give answers to the point for the following questions :

(1) State the difference between a commercial bank and a central bank.

(2) List down the primary and secondary functions of commercial banks and explain each of those in one sentence.

(3) List down the quantitative and qualitative tools of monetary policy and explain each of those in one sentence.

5. Answer the following questions in detail :

(1) Give the meaning of a commercial bank and explain its functions.

(2) Give the meaning of a central bank and explain its functions.

(3) Explain the quantitative measures of monetary policy in detail.

Glossary

Bank	: A bank is a commercial organization functioning for profit which accepts peoples' savings in the form of deposits and pays interest in return, it ensures the safety of these deposits, lends money from these deposits to people who need money by charging them with interest and invests the surplus funds for development of the nation.
Credit Creation	: The policy process of banks for lending money from primary deposits and thereby creating new deposits and increased money supply is called credit creation.
Scheduled Banks	: Banking companies which are listed in the 2nd schedule of the RBI Act, 1934 (are established accordingly) are called scheduled banks.
Central Bank	: Central bank is the Apex bank of the country whose function is to aid, regulate and promote the entire money/financial market and the banking sector; as well as to maintain monetary/financial stability for overall economic good of the nation.
Monetary Policy	: The policy undertaken by the apex bank for regulating the supply of money in order to maintain economic stability keeping into consideration the process of economic development and interest of the public is called monetary policy.
Primary Deposits	: Deposits in the form of initial public savings with banks are called primary deposits.
Secondary Deposits	: Additional deposits derived by banks when loans created from primary deposits are accounted in banks are called secondary deposits.
Government Securities	: Interest bearing bonds floated by government in the market to raise money, which are purchased by people and are repurchased by the government after a fixed period are called government securities in simple terms.
Store of value function of Money	: Store of value function of money implies that money is stored, exchanged with other currencies or mobilized to enhance its own worth or to enhance wealth.

●