OVERVIEW OF FINANCIAL STRUCTURE
Paper – VI Business Environment
MBA (Evening) 3rd Year

COVERAGE

- What is Banking?
- Types of Banks – Central / Commercial / Development etc. and their function
- Central Bank
  - Functions
  - Instruments for control of credit
  - Maintaining Foreign Exchange Rates [EXPLORE THE MECHANISM]
  - Slack / Busy Season Policy [SHORT NOTE]
- Non Banking Financial Companies – Role, Development and functions
- Development Banking
  - Role of RBI / NABARD [SHORT NOTE]
- Development Financial Institutions
  - Role of SIDBI / IDBI [SHORT NOTE]

MAIN REFERENCES

Indian Economy – Problems of development and planning
Silver Jubilee (1999) Edition
By A.N. Agarwal. Publisher – Wishwa Publisher

Topic Area	Chapter
1. Role of RBI / NABARD / Commercial banks / credit co-operatives in agricultural financing	21
2. Financial Institutions – Role in Industrial Financing	31
3. Reserve Bank and Monitory Policy	37
4. Commercial Banks	38

OTHER BOOKS FOR REFERENCE

Indian Economy
By Mishra & Puri

Indian Economy
By Dutt & Sundaram

NOTE:

1. Students are advised that this handout is meant as a guide and as a short introduction to the main topic. It should not be confused with course material.

2. Students should treat the handout as indicative outline as to how to approach the topic under consideration. They are expected to build up their answers taking into consideration the reference material – given above and in the course – along with class notes, newspaper & magazines etc. Answers by the students should reflect an understanding of the theory and it's implications in the current economic scenario incorporating recent changes, if any.

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CENTRAL BANK – FUNCTIONS & INSTRUMENTS

FUNCTIONS OF CENTRAL BANK:

1. Monopoly of note creation: Note issue is the sole privilege of the central bank of the country and notes issued by it are considered to be full legal tender.

2. Bankers to the government: The central bank keeps the banking account of the government. It performs the same function for the government that the commercial banks perform for the general public like accepting government deposit, collecting cheque's etc. In addition, it makes loan – both ordinary and extraordinary – to the government. It also plays a key role in managing public debt and also acts as a financial advisor to the government.

3. Bankers to other banks: The central bank acts as a banker to other banks in three capacities – (i) as a custodian to cash reserve of commercial bank (ii) as a lender of the last resort and (iii) clearing house for settlements and transfers

4. Control of Credit: The central bank using various instruments controls the volume and the direction of credit. It is the most important function of the central bank – as the price levels and employment are directly dependent on the volume of credit.

5. Maintenance of exchange rate: The central bank of a country actively keeps stable the foreign exchange value of the home currency. A stable exchange rate – which is necessary for foreign trade – is maintained by buying and selling foreign currencies in required volume.

6. Custodian of national reserve: Central bank acts as a custodian of the national reserves of gold, precious metals and foreign exchange.

7. Promoter of economic development: In underdeveloped countries, the central bank is also forced to act as a purveyor of development – by actively engaging in development of rural credit and / or special financial credit. [EXPLORE WHY THIS ROLE IS NECESSARY IN LDC's AS A SHORT NOTE]

INSTRUMENTS FOR CONTROL AND REGULATION OF CREDIT:

a. QUANTITATIVE MEASURES

1. Bank Rate: Also known as "Discount Rate" – is the lending rate of the central bank to other commercial banks. If the central bank wants to check credit expansion, it raises the bank rate. This forces the commercial banks to increase their lending rate to the public thereby increasing the cost of credit for investment purposes. On the other hand it makes savings an attractive option and in the process it leads to curtailment of credit.

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2. Open market operations: Purchase and sale of government securities and bonds in the capital markets by the central bank is known as “open market operations”. To curtail the expansion of credit, the central bank sells securities and bonds and to expand credit it buys securities and bonds. Open market operations generally tend to be short tem in nature.

3. Statutory liquidity ration(SLR): Commercial banks are dictated by the central bank to maintain a certain percentage of their assets in liquid form. This percentage is known as the statutory liquidity ratio. When the central bank wants to curtail credit expansion it increases the SLR. This in turn forces the commercial banks to keep a larger reserve and thus limit the available credit to the economy.

4. Cash Reserve Ratio(CRR): All the commercial banks are forced to maintain a percentage of their reserves with the central bank. This percentage of reserve is known as CRR. When the central bank wishes to curtail credit it increases the CRR thereby forcing the commercial banks to keep more reserves with the central bank and thus reducing the amount available for credit to the economy.

b. QUALITATIVE MEASURES

5. Regulation of consumer credit: Central bank may dictate the amount of credit that can be given to a financial institution and thus curtail credit.

6. Moral Persuasions: A friendly request by the central bank to other commercial banks to regulate or expand credit is known as moral persuasions.

7. Direct Action: Central bank is also empowered to take coercive actions against commercial banks like refusing credit or refusing credit etc. When the central bank takes such coercive actions the process is known as direct action.

8. Credit Rationing: Central bank resorts to ration the amount of credit available to the commercial banks. This process is known as credit rationing.

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