# SNS COLLEGE OF TECHNOLOGY

**(An Autonomous Institution)**

**COIMBATORE-35**

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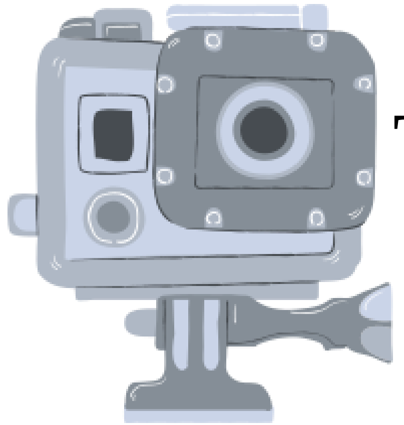
## DEPARTMENT OF ELECTRICAL AND ELECTRONICS ENGINEERING

## COURSE NAME: 19MEE301/ ENGINEERING ECONOMICS AND COST ANALYSIS

III YEAR / V SEMESTER

Unit 3-ORGANISATION



Topic : CONTROL OF CREDIT & CREDIT INSTRUMENT

# Introduction:

- The most important function of the central bank ( RBI ) is to control credit created by commercial banks. Money & credit represent a powerful force to good or evil in the economy. It is the duty of the central bank to ensure that money & credit is properly managed so that inflationary & deflationary pressures can be control by the economy.



# CREDIT CONTROL BY RBI

- Commercial banks create credit in the process of lending. They have the power of credit creation. The important of credit in the settlement of business transactions has increased. There has been a shift from money economy to credit economy in which traders & businessmen are able to carry out their business transactions without immediate payment or receipt of money.
- Neither too much nor to little credit is desirable for the economy.
- The control over the volume or quantity of credit created is one aspect of credit control. The central bank also has the responsibilities to control the direction of credit flow in line with the overall economic priorities.

# IMPORTANCE OF CREDIT CONTROL

1) To obtain stability in the internal price level.
2) To attain stability in exchange rate.
3) To stabilize money market of a country.
4) To eliminate business cycles –inflation & depression –by controlling supply of credit.
5) To maximize income, employment & output in a country.
6) To meet the financial requirements of an economy not only during normal times but also during emergency or war
7) To help the economic growth of a country within specified period of time.

# Methods and instruments of credit control

## Quantitative Or General Methods

1. Bank Rate
2. Open Market Operations
3. Variable Cash Reserve Ratio
4. Statutory Liquidity Ratio

## Qualitative Or Selective Methods

1. Rationing Of Credit
2. Margin Requirements
3. Regulation Of Consumer Credit
4. Control Through Directives
5. Publicity
6. Moral Suasion
7. Direct Action

# Methods / instruments of credit control

## A. Quantitative methods:-

- Quantitative methods are those which aim at controlling the total volume of credit. They are used to regulate the quantity of credit created by banks. By using these methods the central banks controls the amount of credit.
- These includes:-
  1. Bank rate
  2. Open market operations
  3. Variable cash reserve ratio
  4. Statutory liquidity ratio

# 1. Bank Rate

- Bank rate is the rate at which central bank ( RBI in India ) grant loans to the commercial banks against the Govt. security & other approved first class securities.
- Reserve Bank adopts **Cheap & Dear Monetary Policy** according to economic condition of the country

a. **Cheap Monetary Policy :-**

RBI decreases bank rate to increase the quantity of credit in the country, this is called cheap monetary policy.
Decrease in bank rate » decrease cost of credit i.e. Decrease in interest rate …
As a result of this quantity of credit increases.

b. **Dear Monetary Policy :-**

RBI increases bank rate to decrease the quantity of credit in the country, this is called dear monetary policy.
increase in bank rate » increase cost of credit i.e. increase in interest rate …
this will result in decrease in quantity of credit.

**( Current bank rate is 6.25% )**

## 2. Open market operations

- **Open Market Operations** refers to the deliberate & direct buying & selling of securities & bills in the money market by the central bank.
- Purchase & sells of securities may lead to expansion & contraction of money supply in the money market. It influences the cash reserves with the commercial banks & hence these operation control their credit creation power.
- **Inflationary pressure**:- the central bank would sell the govt. securities to the commercial banks. the banks would transfer a part of their cash reserves to the central bank towards the payments of these securities. Consequently the cash reserves with the commercial banks will be reduced. It would lead to a contraction in the credit creation power of the commercial banks.
- **Deflationary pressure** :- in this situation the central bank will purchase securities from the commercial banks. In the process the cash reserves with the commercial bank will increase & they would be enable to create more credit
- This weapon is used to fulfill the seasonal credit requirements of commercial banks.

# 3. Cash Reserve Ratio

- The RBI controls credit through change in Cash Reserve Ratio (CRR ) of commercial banks.
- Every commercial bank is required by law to maintain certain percentage of its deposit with the central bank which is called cash reserve ratio.
- The central bank has a power to change the percentage of cash reserve to be kept with it.
- If the ratio increases the credit creation capacity of commercial banks decreases. On the other hand if the ratio decreases the credit creation capacity if commercial banks increases.
- This ratio can be varied from 3 % to 15% as directed by the RBI.
- By changing the reserve requirement, the central bank is able to effect the amount of cash with the commercial banks & force them to curtail or expand credit.

**( Current CRR is 4% )**

# 4. Statutory liquidity ratio

- Every scheduled bank is required by law to maintain a minimum of 20% as cash , gold or unencumbered securities of its total demand & time liabilities, which is called Statutory liquidity ratio ( SLR )
- The RBI is empowered to change this ratio.
- It is also influence the credit creation capacity of the banks
- The effect of both CRR & SLR on credit expansion is similar.
- As on Oct 21, 1997, it was fixed to 25% of the total deposit of the commercial banks.
- Penalties are levied by RBI for not maintaining these ratio's from scheduled banks.

**( Current SLR is 20% )**

## B. QUALITATIVE METHODS :-

- Qualitative methods are used to effect the use, distribution & direction of credit.
- It is used to encourage such economic authorities as desirable & to discourage those which are injurious for the economy.
- RBI from time to time had adopted the following qualitative methods of credit control:-
  1. Rationing Of Credit
  2. Margin Requirements
  3. Regulation Of Consumer Credit
  4. Control Through Directives
  5. Publicity
  6. Moral Suasion
  7. Direct Action

## 1. Rationing Of Credit

- In this method RBI seeks to limit the maximum or ceiling of loans & advances and also in certain cases, fixes ceiling for specific categories of loans & advances.
- It aims to control & regulate the purposes for which the credit is granted by commercial banks.

a) **Variable portfolio ceiling:-**
According to this the central bank fixes a ceiling on the amount of loans & advances for each bank & the bank cannot advance loans beyond this limit.

b) **Variable capital asset ratio :-**
This is the ratio which the central bank fixes in relation to the capital of a bank to its total assets.

# 2. Margin Requirements

- Commercial banks do not lend up to the full amount of the value of security. the loan amount is lass than the securities value. It keeps a **‘margin’** as a cushion against fall in the value of the security.
- ‘margin’ refers to the difference between the current market value and the loan value of a security. It is a portion of the value of the security charged to a bank, which the borrower is expected to pay out of his own resources.
- a rise in the margin requirement restricts the amount of loan that a bank can grant against a security , while a lower margin increases it.
- In this way, the amount of fixing margin requirements has a direct impact on the amount of credit for speculation purposes.
- during depression, the margin can be reduced so that there is increase in the level of economic activity through an increase in demand for bank credit.

  conversely, during inflation, margin requirements can be raised by the monetary authorities so as to contain the boom in the stock market.

# 3. Regulation Of Consumer Credit

- With the introduction of installment trading, the trading in non-essential consumer products like motor vehicles, electrical & electronic goods have gone up to an unpredicted level.
- The RBI may restrict consumer expenses on non-essential items by directing the commercial banks to fix the minimum percentage of down payment, length of period over which installment payment may be spread, etc.
- Example :-

  suppose, to buy a washing machine, the buyer is required to make a down payment of one-fourth of its total price & the rest is to be paid in 15 equal monthly installment.

  under regulation of consumer' credit, the down payment amount may be increased & number of installments reduced. This reduce demand for the product & controls consumer spending which is necessary for controlling prices.
- During inflation, more restrictions can be prescribed to control prices by controlling demands, while during depression they can be relaxed in order to stimulate demand for goods.

# 4. Control Through Directives

- RBI have been empowered to issue directives to commercial banks in respect of their lending policies, purposes for which loans may or may not be granted , margin to be kept in case of secured loan ,etc.
- The power to issue directives may be given either by statute or by mutual agreement between the central banks and the commercial banks.
- Directives may be issued to encourage the flow of credit to certain areas or to prevent the flow of credit in undesirable directions.

## 5. Publicity

- The RBI may also follow the policy of publicity in order to make known to the public its view about the credit expansion or contraction.
- RBI regularly publish statements of assets & liabilities of commercial banks for information to the public. They also publish reports of general money market & banking condition.
- This is a way of exerting moral pressure on the commercial banks & also making the public aware of the policies being adopted by banks & the central bank in the light of prevailing economic conditions in the country.

## 6. Moral Suasion

- It refers to the advise or request made by the central bank to the commercial banks to follow the monetary policy and carry out their lending activities & other operations in such a way as to achieve the objective of the central banks policy.
- It can be in the form of advise to commercial banks regarding their investments or care to be taken while granting loans & advances against such commodities the prices of which may rise due to speculative activity.
- Being an apex institution & lender of the last resort , the RBI can used its more pressure & persuade the commercial bank to follow its policy.

# 7. Direct Action

Direct action refers to the direction & controls which the central bank may enforce on all banks or a particular bank concerning their lending & investments.

In such case:-

1) RBI may refuse to sanction further accommodation to a bank.
2) The RBI may reject altogether any application for grant of discounting facilities to the bank.
3) It may change penal rate of interest on loans taken by a bank beyond the prescribed limit.

# Conclusion

In modern times , bank credit has become the important source of money and commercial banks have unlimited power to expand or contract credit . for smooth functioning of the economy RBI controls credit through quantitative & qualitative methods. RBI encourage credit for productive purposes & discourage credit for non-productive purposes.

# Thank You!