UNIT – III

Central bank and monetary policy

RBI functions · Credit control · Monetary policy · Index numbers

Explanatory Lecture Slides

Money, Banking & International Trade · Major-2 · Semester II

MONEY, BANKING & INTERNATIONAL TRADE

LEARNING OBJECTIVES

Topics covered in this unit

01 **State functions of a central bank**

02 **Explain quantitative and qualitative credit control**

03 **Define monetary policy and its objectives**

04 **Place the MPC and the 4% CPI target**

05 **Write a note on index numbers**

06 **Connect policy to inflation from Unit I**

How this unit is organised

01	02	03	04	05	06
Central-bank functions	Bank of issue	Credit control	Repo & CRR	Monetary policy	Index numbers

Functions of a central bank

Bank of issue, banker to government, banker to banks, lender of last resort, foreign-exchange manager, supervisor, monetary-policy authority.

- PYQ: functions of central bank (2021).
- RBI was created by the RBI Act 1934; nationalised in 1949.
- Lender of last resort is Bagehot’s function — against a liquidity panic, not against insolvency.

Functions of a central bank

CLASSIC FIVE

- Issue.
- Government banker.
- Bankers’ bank.
- LoLR.
- Forex.

MODERN

- Supervision.
- MPC.
- Payment systems (UPI sits nearby at NPCI, not RBI itself — do not mix).

Credit-control instruments

Quantitative: CRR, SLR, repo, reverse repo, OMO, bank rate. Qualitative: margin, moral suasion, selective credit, credit rationing.

- PYQ: methods of credit control (2023, 2025).
- Tight policy: raise repo / CRR — dearer credit, slower M.
- Cheap policy: the reverse — used in slumps, risky if inflation is live.

Credit-control instruments

QUANTITATIVE	QUALITATIVE
• Hit the cost and quantity of reserves.	• Hit the direction of credit (priority sector, margins).

Monetary policy — objectives

Price stability, growth, financial stability, sometimes exchange-rate calm. In India, flexible inflation targeting is statutory.

- PYQ: objectives of monetary policy (2022); functions of central bank in policy (2023 Oct).
- Conflicts: cheap credit for growth v dear credit for inflation.
- Transmission: repo → bank lending rates → I and C — often slow in India.

Monetary policy — objectives

PRIMARY IN LAW NOW

- CPI inflation target around 4% ±2% (notified).

SECONDARY

- Growth.
- Stability of the financial system.

Index numbers

A device to measure relative change in a group (prices, quantity). Laspeyres, Paasche, Fisher.

- PYQ: define index number, steps, difficulties (2022).
- CPI v WPI: CPI is the MPC’s star.
- Steps: purpose, commodities, weights, base year, formula, splicing.
- Difficulties: choice of base, quality change, new goods, rural/urban.

Index numbers

CPI

- Consumer basket.
- RBI target.

WPI

- Wholesale.
- Still in news; not the target.

Bank rate, repo, CRR — do not confuse

A 6-mark trap.

- Bank rate: the classic long-term signalling rate.
- Repo: the operating rate at which RBI injects liquidity against securities.
- CRR: a fraction of NDTL to be kept with RBI, earning no interest in the old story (check current treatment in a footnote if you can).
- SLR: liquid assets the bank must hold — a stock, not a rate.

Bank rate, repo, CRR — do not confuse

FLOW TOOL	STOCK TOOL
• Repo / reverse repo.	• CRR. • SLR.

Independence and accountability

A central bank needs operational freedom and a statutory mandate — not a weekly ministerial telegram.

- MPC (2016 amendment) is the Indian compromise: government sets the target, RBI/MPC sets the rate.
- Failure to meet the target requires a written explanation to the government.
- Useful one-liner in a ‘functions’ answer: issue, banker, LoLR, supervisor, MPC.

Independence and accountability

MANDATE

- RBI Act + government notification of the target.

VOICE

- Minutes of the MPC — a legal-methods style primary source.

Index numbers

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LANDMARK AUTHORITIES

Cases a KSLU answer should name

CASE

RBI v Peerless

(1996) 1 SCC 642

RBI as a specialist regulator — courts defer on monetary-technical questions more than on rights.

CASE

Joseph Kuruvilla Vellukunnel v RBI

AIR 1962 SC 1371

RBI’s power to restrict a bank — an early constitutional look at banking regulation.

CASE

Jayantilal N. Mistry

(2016) 3 SCC 525

RTI and RBI inspections — accountability of the supervisor.

STATUTE / SECTION MAP

Provisions & materials to quote

RBI Act 1934 Ch. IIIF	Monetary Policy Committee.
RBI Act s.3	Establishment of the Bank.
BR Act s.21, s.35A	Credit-policy directions and extra powers.
Payment and Settlement	RBI as settlement overseer.
FRBM Act 2003	The fiscal cousin — monetary policy cannot ignore the deficit.

WRITE IT IN THE HALL

10 / 16-mark frames from this unit

Q1 Explain the functions of a central bank.

Q2 Discuss the methods of credit control used by RBI.

Q3 What is monetary policy? State its objectives.

Q4 Define an index number. How is a price index constructed? What difficulties arise?

BEFORE YOU CLOSE THE FILE

Unit recap

1. RBI: issue, government banker, bankers’ bank, LoLR, supervisor, MPC.
2. Repo is the operating rate; CRR/SLR are stocks.
3. Flexible inflation targeting is the statutory objective.
4. CPI, not WPI, is the target index.
5. Quantitative tools hit quantity; qualitative tools hit direction.