CHAPTER TWO
CENTRAL BANKING

INTRODUCTION

- A **central bank**, **reserve bank**, or **monetary authority** is an institution that manages a state's currency, money supply, and interest rates.
- Central banks also usually oversee the commercial banking system of their respective countries.

- In contrast to a commercial bank, a central bank possesses a monopoly on increasing the amount of money in the nation, and usually also prints the national currency, which usually serves as the nation's legal tender.
- The primary function of a central bank is to manage the nation's money supply (monetary policy), through active duties such as managing interest rates, setting the reserve requirement, and acting as a lender of last resort to the banking sector during times of bank insolvency or financial crisis.

- Central banks usually also have supervisory powers, intended to prevent bank runs and to reduce the risk that commercial banks and other financial institutions engage in reckless/irresponsible or fraudulent behavior.
- Central banks in most developed nations are institutionally designed to be independent from ***political interference***.
- Still, limited control by the executive and legislative bodies usually exists.
- The chief executive of a central bank is normally known as the **Governor, President or Chairman.**

ACTIVITIES AND RESPONSIBILITIES

Functions of a central bank may include:

- Implementing monetary policies.
- determining Interest rates
- controlling the nation's entire money supply
- the Government's banker and the bankers' bank ("lender of last resort")

managing the country's foreign exchange and gold reserves and the Government's stock register

regulating and supervising the banking industry

setting the official interest rate – used to manage both inflation and the country's exchange rate – and ensuring that this rate takes effect

- Central Banks differ from country to country in their structure and organization, in their policies and techniques. But their functions are very similar. The Central Bank renders the following important functions in almost all countries:

(i) Issuing of notes and regulating the volume of currency

(ii) Acts as banker to the government

(iii) Acts as banker to the banks

(iv) Acts as custodian of Nation's reserves

(v) Acts as the lender of last resort

(vi) Functions as National Clearing House

(vii) Acts as controller of credit

(viii) Publishes economic statistics and other information

(ix) Development functions

(x) Supervises the activities of financial institutions.

- The Central Bank is legally empowered to issue currency notes.
- The Central Bank is charged with the responsibility of maintaining price stability, inflation level, i.e., the domestic value of its money as well as its external value.
- The supply of money consists of the legal lender money and the bank money.
- The Central Bank has the monopoly power of the note issue to regulate the supply of legal tender money.

- This enables it to impart elasticity to the currency system and to maintain stability in the circulation of money.
- By the function of note issue the central bank achieves the following merits:

(a) Enhance the public confidence on the monetary system.

(b) Maintaining uniformity in the monetary system throughout the country.

(c) Flexibility in the monetary system. By the function of note issue the Central Bank can maintain the circulation of the economy at desired level

(d) Credit creation can be effectively controlled. The sole right of note issue enables the Central Bank to regulate the creation of credit by commercial banks and adjust the supply of money to the demand for it.

(e) Maintaining the internal and external value of money.

Some of their functions and responsibility are:

(i) Minimum Reserve system

- Whatever may be the system three basic principles are to be followed. They are (i) Uniformity (ii) Security and (iii) elasticity. The currency issued must be uniform and a single authority must be vested with the power of note issue to achieve uniformity.

- There must be security for the currency without any dangers of over-issue.
- Public must have confidence in the currency, which to some extent, depends upon the gold and foreign exchange reserves it holds.
- At the same time the currency supply must be elastic.
- The Central Bank must be able to expand or to contract the supply of currency according to the changing needs from time to time.

***(ii)* Banker to the Government:**

- The Central Bank acts as the banker, financial agent and advisor to the government.
- The surplus money of the government is kept with the Central Bank.
- It lends money to both central and state governments.
- It helps the government to tide over the time gap between their expenditure and collection of taxes.
- The Central Bank is usually required to make temporary advances to the government in anticipation of collection of revenues.
- It is necessary that there should be close co-operation between the Central Bank and the government.

- The government is the ultimate authority for laying down the broad monetary policies of the country and Central Bank is the institution for carrying out of such policies.
- The Central Bank as a fiscal agent to the government accepts loans and manages public debts, receives taxes and other payments from the public.
- The government bonds and treasury bills are issued by the Central Bank on behalf of the governments

- As the financial adviser, the Central Bank provides valuable advice to the government on important financial matters like, foreign exchange policy, commercial policy, rising of funds from market, etc.

(iii) Banker to the banks:

- The Central Bank Acts as the bankers' bank. As such it performs the following functions:
- **Custodian of cash reserves of commercial banks:** The commercial banks of the country are required to keep a certain percentage of their deposits with the Central Bank. It secures the advantage of centralized cash reserves

- Such cash reserves with the Central Bank have the following advantages:

(a) The centralization of cash reserve is a source of great strength to the banking system of the country as it strengthens the confidence of the public

(b) Centralized reserves can be used effectively and quickly in times of emergency.

(c) This ensures liquidity and imparts economy in the credit structure of the country.

(d) These reserves promote liquidity of commercial banks as they enable the Central Bank to undertake rediscounting of bills on a more extensive scale for the purpose of meeting the requirements of the money market.

(e) The Central Bank can control credit by varying the cash reserves that commercial banks should keep with it.

***(iv)* Act as custodian of National reserves:**

- Central Bank is the custodian of nation's gold and foreign exchange reserves.
- Previously, to some extent, the value of a currency depends upon the gold reserves or foreign exchange reserves held as the backing for the currency.
- As such, it is the responsibility of the Central Bank to maintain sufficient reserves and to prevent their depletion.

- The Central Bank manipulates the bank rates and takes other steps to conserve the reserves of gold and foreign exchange.
- Some Central Banks have absolute powers to control the foreign exchange reserves and to license the various uses to which the foreign exchange is put to use.
- In modern times, the foreign exchange control has become the essential function of the Central Bank.

(v) Acts as Lender of last resort:

- The Central Bank acts as the lender of last resort and as the bank of rediscount.
- Rediscounting can be defined as conversion of bank credit into Central Bank Credit.
- The commercial banks approach the Central Bank for its financial needs as it is the lender of the last resort or the ultimate source of finance.

- It lends to the commercial banks by rediscounting the eligible bills.
- The rediscounting facilities given by the Central Bank impart elasticity and liquidity to the entire credit structure of the country.
- It helps the commercial banks in a big way to prevent them from bank failures.
- But its assistance is limited only to the banks which suffer from technical insolvency and not to those unsound and really insolvent banks.

- Moreover, a commercial bank is not entitled to financial accommodation simply because it has eligible paper or approved securities.
- Unless it is conducting its business according to sound banking principles, the Central Bank refuses accommodation.
- Thus, the Central Bank is able to control credit while discharging the function of lender of last resort.
- The Central Bank is also regarded as performing the function of last resort when it grants accommodation to the government in times of monetary stringency.

***(vi)* Functions as National clearing house:**

- The Central Bank acts as the national clearing house.
- The maintenance of accounts by all commercial banks with the Central Bank enables it to settle inter-bank indebtedness.
- A clearing house is an institution where interbank claims, i.e., claims of banks against one another are settled.
- The net balances or differences called the clearing balances are settled by mere transfers between their respective accounts at the Central Bank.
- The clearing houses facilitate expeditious and economical settlement of inter-bank claims.

Publishes economic statistics and other information:

- The Central Bank regularly col lects and publishes the statistics regarding various economic activities of the government, banking system, etc.
- Further it provides useful information regarding

Development functions:

- The Central Bank Acts as the catalyst of economic growth of the country.
- It acts as an agency of economic growth. It renders various developmental functions such as

(i) Provision of credit facilities to agricultural industry and other priority sectors through commercial banks and co-operative banks.

(ii) Expansion of banking facilities in the country.

(iii) Maintaining price stability in the country.

(iv) Mitigating the effects of trade cycles by its effective monetary policies, etc.

- The responsibility of the Central Bank is increasing every day and its functions are expanding.
- The well-administered central banking functions are necessary for all the countries especially for the developing countries to maintain price stability and economic growth.

END OF CHAPTER two

THANK YOU