

Chapter Two: Banking System

Central Banking System

Introduction

The central bank is the apex bank in a country. It is called by different names in different countries. It is the Reserve Bank of India in India, the Bank of England in England, the Federal Reserve System in America, the Bank of France in France, the Riksbank in Sweden, National Bank of Ethiopia in Ethiopia, etc.

Definition of a Central Bank

A central bank has been defined in terms of its functions. According to Vera Smith, "The primary definition of central banking is a banking system in which a single bank has either complete control or a residuary monopoly of note issue,"

W.A. Shaw defines a central bank as a bank which controls credit.

To Hawtrey, a central bank is that which the lender of the last resort is. According to A.C.L Day, a central bank is "to help control and stabilize the monetary and banking system." According to Sayers, the central bank "is the organ of government that undertakes the major financial operations of the government and by its conduct of these operations and by other means, influences the behavior of financial institutions so as to support the economic policy of the government. "Sayers refers only to the nature of the central bank as the government's bank. All these definitions are narrow because they refer only to one particular function of a central bank.

On the other hand, Samuelson's definition is wide. According to him, a central bank "is a bank of bankers. Its duty is to control the monetary base . . . and through control of this 'high-powered money' to control the community's supply of money." But the broadest definition has been given by De Kock. In his words, a central bank is "a bank which constitutes the apex of the monetary and banking structure of its country and which performs as best as it can in the national economic interest, the following functions: (i) The regulation of currency in accordance with the requirements of business and the general public for which purpose it is granted either the sole right of note issue or at least a partial monopoly thereof. (ii) The performance of general banking and agency for the state. (iii) The custody of the cash reserves of the commercial banks. (iv) The custody and management of the nation's reserves of international currency. (v) The granting of accommodation in the form of re-discounts and collateral advances to commercial banks, bill brokers and dealers, or other financial institutions and the general acceptance of the responsibility of lender of the last resort. (vi) The settlement of clearance balances between the banks. (vii) The control of credit in accordance with the needs of business and with a view to carrying out the broad monetary policy adopted by the state."

Evolution of Central Banking

The word 'bank' is of Germanic origin though some persons trace its origin to the French word 'Banqui' and the Italian word 'Banca'. It referred to a bench for keeping, lending, and exchanging of money or coins in the market place by money lenders and money changers.

The Central Bank is a financial institution charged with several different functions, the most important of which is managing a country's monetary policy. In addition, central banks typically manage a government's debt, they participate in the formulation of exchange rate policy, together with the government, and in many countries they are the principal regulator for the financial sector. Modern central banks were first developed during the late seventeenth century, most notably with the foundation of the Bank of England in 1694. While many major central banks before 1945 were privately owned, today central banks operate as agencies of government. Recently, there has been much debate over the extent to which central banks should be independent from political control when they set monetary policy. During the post-war period governments in many (OECD) organizations for economic cooperation and development countries retained the authority to intervene with or override central bank decisions. This was a provision seen as a necessary corrective to the perceived failure of policies pursued by several central banks during the 1930s. Since the 1980s, with the increasing popularity of rational expectations models of monetary policy and the perceived post-war success of independent central banks like Germany's Bundesbank, it has become increasingly popular to emphasize the benefits of making central banks independent from day-to-day political interference.

Institution, such as the U.S. [Federal Reserve System](#), charged with regulating the size of a nation's [money supply](#), the availability and cost of [credit](#), and the foreign exchange value of its [currency](#) ([foreign exchange](#)). Central banks act as the fiscal agent of the government, issuing notes to be used as legal tender, supervising the operations of the commercial banking system, and implementing [monetary policy](#). By increasing or decreasing the supply of money and credit, they affect interest rates, thereby influencing the economy. Modern central banks regulate the money supply by buying and selling assets (e.g., through the purchase or sale of government securities). They may also raise or lower the [discount rate](#) to discourage or encourage borrowing by [commercial banks](#). By adjusting the reserve requirement (the minimum cash reserves that banks must hold against their deposit liabilities), central banks contract or expand the money supply. Their aim is to maintain conditions that support a high level of employment and production and stable domestic prices. Central banks also take part in cooperative international currency arrangements designed to help stabilize or regulate the foreign exchange rates of participating countries. Central banks have become varied in authority, autonomy, functions, and instruments of action, but there has been consistent increased

emphasis on the interdependence of monetary and other national economic policies, especially [fiscal policies](#) and debt management policies.

Government agency that performs a number of key functions: (1) issues the nation's currency; (2) regulates the supply of credit in the economy; (3) manages the external value of its currency in the foreign exchange markets; (4) holds deposits representing reserves of other banks and other central banks; (5) acts as [Fiscal Agent](#) for the central government, when the government sells new issues of securities to finance its operations; and (6) attempts to maintain an orderly market in these securities by actively participating in the government securities market.

The [Federal Reserve System](#), the central bank in the United States, regulates [Bank Credit](#) by raising or lowering the [Discount Rate](#) and by buying and selling government securities in the open market. This process, known as [Open Market Operations](#), aims to promote stable economic growth while controlling the rate of inflation. Other major central banks are the Bank of England, the European Central Bank, and the Bank of Japan.

Central bank, financial institution designed to regulate and control the money supply of a nation, with the goal of fostering economic growth without inflation. Although central banking systems have varying levels of autonomy, there is generally a significant level of government control. The responsibilities of the central bank usually include maintaining adequate reserve backing for the nation's commercial banks and regulating the exchange rate of the nation's currency. Such duties are met by controlling the discount rate, making reserve advances to commercial banks, trading in government obligations, and acting as the government's fiduciary agent in its dealings with other governments and other central banks. The central bank has been called the "lender of last resort" and is expected to lend to its nation's banks at any time, particularly during a [panic](#). Although the term was hardly known before 1900, the concept of central banking dates back to at least 1694, when the Bank of England was founded. Today, all economically developed nations-and most developing nations-possess the equivalent of a central bank; there are 172 central banks around the world. Notable central banks include France's Banque de France, Germany's Bundesbank, and the U.S. [Federal Reserve System](#). The Bank for International Settlements in Switzerland serves as a central bank for the central banks of the world's largest capitalist nations. The World Bank and the International Monetary Fund also serve certain central banking functions for member nations. The European Union established the European Central Bank in 1998 as a prelude to the adoption of the euro ([European Monetary System](#)). In the United States, the inflation crisis of the late 1970s led to greater public awareness of the role of the Federal Reserve in setting interest rates; reaction to its decisions (and expected decisions) concerning interest rates often produces sharp movements in the stock and bond markets.

Difference between Central Bank and Commercial Bank

A central bank is basically different from a commercial bank in the following ways:

1. The central bank is the apex institution of the monetary and banking structure of the country whereas commercial bank is one of the organs of the money market.
2. The central bank is a non-profit institution which implements the economic policies of the government. But the commercial bank is a profit-making institution.
3. The central bank is owned by the government, whereas the commercial bank is owned by shareholders.
4. The central bank is a banker to the government and does not engage itself in ordinary banking activities. The commercial bank is a banker to the general public.
5. The central bank has the monopoly of note issue, while the commercial bank can issue only cheques. The notes are legal tender. But the cheques are in the nature of near-money.
6. The central bank is the banker's bank. As such, it grants accommodations to commercial banks in the form of rediscount facilities, keeps their cash reserves, and clears their balances. On the other hand, the commercial bank advances loans to and accepts deposits from the public.
7. The central bank controls credit in accordance with the needs of business and economy. The commercial bank creates credit to meet the requirements of business.
8. The central bank helps in establishing financial institutions so as to strengthen money and capital market in a country. On the other hand, the commercial bank helps industry by underwriting shares and debentures, and agriculture by meeting its financial requirements through cooperatives or individually.
9. Every country has only one central bank with its offices at important centers of the country. On the other hand, there are many commercial banks with hundreds of branches within and outside the country.
10. The central bank is the custodian of the foreign currency reserves of the country while the commercial bank is the dealer of foreign currencies.
11. The chief executive of the central bank is designated as "Governor" whereas the chief executive of a commercial bank is called 'Chairman' or 'President'.

Functions of a Central Bank

A central bank performs the following functions, as given, by De Kock and accepted by the majority of economists.

1. Regulator of Currency

The central bank is the bank of issue—it has the monopoly of note issue. Notes issued by it circulate as legal tender -money. It has its issue department which issues notes and, coins to commercial banks. Coins are manufactured in the government mint but they are put into circulation through the central bank. Central banks have been following different methods of note issue in different countries. The central bank is required by law to keep a certain amount of gold and foreign securities against the

issue of notes. In some countries, the amount of gold and foreign securities bears a fixed proportion, between 25 to 40 per cent of the total notes issued. In other countries, a minimum fixed amount of gold and foreign currencies is required to be kept against note issue by the central bank.

The monopoly of issuing notes vested in the central bank ensures uniformity in the notes issued which helps in facilitating exchange and trade within the country. It brings stability in the monetary system and creates confidence among the public. The central bank can restrict or expand the supply of cash according to the requirements of the economy. Thus, it provides elasticity to the monetary system. By having a monopoly of note issue, the central bank also controls the banking system by being the ultimate source of cash. Last but not the least, by entrusting the monopoly of note issue to the central bank, the government is able to earn profits from printing notes whose cost is very low as compared with their face value.

2. Banker, Fiscal Agent and Adviser to the Government

Central banks everywhere act as bankers, fiscal agents and advisers to their respective governments. As banker to the government, the central bank keeps the deposits of the central and state governments and makes payments on behalf of governments. But it does not pay interest on government deposits. It buys and sells foreign currencies on behalf of the government. It keeps the stock of gold of the government. Thus it is the custodian of government money and wealth. As a fiscal agent, the central bank makes short-term loans to the government for a period not exceeding 90 days. It floats loans, pays interest on them, and finally repays them on behalf of the government. Thus it manages the entire public debt. The central bank also advises the government on such economic and money matters as controlling inflation or deflation, devaluation or revaluation of currency, deficit financing, balance of payments, etc.

3. Custodian of Cash Reserves of Commercial Banks

Commercial banks are required by law to keep reserves equal to a certain percentage of both time and demand deposits liabilities with the central bank. It is on the basis of these reserves that the central bank transfers funds from one bank to another to facilitate the clearing of cheques. Thus the central bank acts as the custodian of the cash reserves of commercial banks and helps in facilitating their transactions. There are many advantages of keeping the cash reserves of the commercial banks with the central bank, according to De Kock. In the first place, the centralization of cash in the central bank is a source of strength to the banking system of a country. Secondly, centralized cash reserves can serve as the basis of a large and more elastic structure than if the same amount were scattered among the individual banks. Thirdly, centralized cash reserves can be utilized fully and most effectively during periods of seasonal strains and in financial crises or emergencies. Fourthly, by varying these cash reserves the central bank can control the credit creation by commercial banks. Lastly, the central bank can provide additional funds on a temporary and short term basis to commercial banks to overcome their financial difficulties.

4. Custody and Management of Foreign Exchange Reserves

The central bank keeps and manages the foreign exchange reserves of the country. It is an official reservoir of gold and foreign currencies. It sells gold at fixed prices to the monetary authorities of other countries. It also buys foreign currencies at international prices. Further, it fixes the exchange rates of domestic currency in terms of foreign- currencies. It holds these rates within narrow limits in keeping with its obligations as a member of the International Monetary Fund and tries to bring stability in foreign exchange rates. Further, it manages exchange control operations by supplying foreign currencies to importers and persons visiting foreign countries on business, studies, etc. in keeping with the-rules laid down by the government.

5. Lender of the Last Resort

De Kock regards this function as a *sine qua non* of central banking. By granting accommodation in the form of re-discounts and collateral advances to commercial banks, bill brokers and dealers, or other financial institutions, the central bank acts as the lender of the last resort. The central bank lends to such institutions in order to help them in times of stress so as to save the financial structure of the country from collapse.

6. Clearing House for Transfer and Settlement

As bankers' bank, the central bank acts as a clearing house for transfer and settlement of mutual claims of commercial banks. Since the central bank holds reserves of commercial banks it transfers funds from one bank to other banks to facilitate clearing of cheques. This is done by making transfer entries in their accounts on the principle of book-keeping. To transfer and settle claims of one bank upon others, the central bank operates a separate department. This department is known as the "clearing house" and it renders the service free to commercial banks.

When the central bank acts as a clearing agency, it is time-saving and convenient for the commercial banks to settle their claims at one place. It also economizes the use of money. "It is not only a means of economizing cash and capital but is also a means of testing at any time the degree of liquidity which the community is maintaining.

7. Controller of Credit

The most important function of the central bank is to control the credit creation power of commercial bank in order to control inflationary and deflationary pressures within this economy. For this purpose, it adopts quantitative methods and qualitative methods. Quantitative methods aim at controlling the cost and quantity of credit by adopting bank rate policy, open market operations, and by variations in reserve ratios of commercial banks. Qualitative methods control the use and direction of credit. These involve selective credit controls and direct action. By adopting such methods, the central bank tries to influence and control credit creation by commercial banks in order to stabilize economic activity in the country.

Central Bank as the Controller of Credit

Meaning of Credit

The word "credit" is derived from the Latin word *creditum* which means to believe or trust. In economics, the term credit refers to a promise by one party to pay another for money borrowed or goods or services received. It is a medium of exchange to receive money or goods on demand at some future date. R.P. Kent defines credit as the right to receive payments or the obligation to make payment on demand at some future time on account of the immediate transfer of goods.

Objectives of Credit Control

Credit control is the means to control the lending policy of commercial banks by the central bank. The central bank controls credit to achieve the following objectives:

1. *To Stabilize the Internal Price Level.* One of the objectives of controlling credit is to stabilize the price level in the country. Frequent changes in prices adversely affect the economy. Inflationary or deflationary trends need to be prevented. This can be achieved by adopting a judicious policy of credit control.
2. *To Stabilize the Rate of Foreign Exchange.* With the change in the internal prices level, exports and imports of the country are affected. When prices fall, exports increase and imports decline. Consequently, the demand for domestic currency increases in the foreign market and its exchange rate rises. On the contrary, a rise in domestic prices leads to a decline in exports and an increase in imports. As a result, the demand for foreign currency increases and that of domestic currency falls, thereby lowering the exchange rate of the domestic currency. Since it is the volume of credit money that affects prices, the central bank can stabilize the rate of foreign exchange by controlling bank credit.
3. *To Protect the Outflow of Gold.* The central bank holds the gold reserves of the country in its vaults. Expansion of bank credit leads to rise in prices which reduce exports and increase imports, thereby creating an unfavorable balance of payments. This necessitates the export of gold to other countries. The central bank has to control credit in order to prevent such outflows of gold to other countries.
4. *To Control Business Cycles.* Business cycles are a common phenomenon of capitalist countries which lead to periodic fluctuations in production, employment and prices. They are characterized by alternating periods of prosperity and depression. During prosperity, there is large expansion in the volume of credit, and production, employment and prices rise. During depression, credit contracts, and production, employment and prices fall. The central bank can counteract such cyclical fluctuations through contraction of bank credit during boom periods, and expansion of bank credit during depression.
5. *To Meet Business Needs.* According to Burgess, one of the important objectives of credit control is the "adjustment of the volume of credit to the volume of business." Credit is needed to meet the requirements of trade and industry. As business expands, larger quantity of credit is needed, and when business contracts less credit are needed. Therefore, it is the central bank which can meet the requirements of business by controlling credit.

6. *To Have Growth with Stability.* In recent years, the principal objective of credit control is to have growth with stability. The other objectives, such as price stability, foreign exchange rates stability, etc., are regarded as secondary. The aim of credit control is to help in achieving full employment and accelerated growth with stability in the economy without inflationary pressures and balance of payments deficits.

Methods of Credit Control

The central bank adopts two types of methods of credit control. They are the quantitative and qualitative methods. *Quantitative* methods aim at controlling the cost and quantity of credit by adopting such techniques as variations in the bank rate, open market operations, and variations in the reserve ratios of commercial banks. On the other hand, *qualitative methods* control the use and direction of credit. These involve selective credit controls and direct action.

1. Bank Rate or Discount Rate Policy

The bank rate or the discount rate is the rate fixed by the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. The bank rate is the interest rate charged by the central bank at which it provides rediscount to banks through the *discount window*. The central bank controls credit by making variations in the bank rate. If the need of the economy is to expand credit, the central bank lowers the bank rate. Borrowing from the central bank becomes cheap and easy. So the commercial banks will borrow more. They will, in turn, advance loans to customers at a lower rate. The market rate of interest will be reduced. This encourages business activity, and expansion of credit follows which encourages the rise in prices.

The opposite happens when credit is to be contracted in the economy. The central bank raises the bank rate which makes borrowing costly from it. So the banks borrow less. They, in turn, raise their lending rates to customers. The market rate of interest also rises because of the tight money market. This discourages fresh loans and puts pressure on borrowers to pay their past debts. This discourages business activity. There is contraction of credit which depresses the rise in price. Thus lowering the bank rate offsets deflationary tendencies and raising the bank rate controls inflation.

2. Open Market Operations

Open market operations are another method of quantitative credit control used by a central bank. This method refers to the sale and purchase of securities, bills and bonds of government as well as private financial institutions by the central bank. But in its narrow sense, it simply means dealing only in government securities and bonds. There are two principal motives of open market operations. *First*, it serves to influence the reserves of commercial banks in order to control their power of credit creation. *Secondly*, it serves to affect the market rates of interest so as to control the commercial bank credit.

3. Variable Reserve Ratio

Variable reserve ratio (or required reserve ratio or legal minimum requirements), as a method of credit control was first suggested by Keynes in his *Treatise on Money* (1930) and was adopted by the Federal Reserve System of the United States in 1935.

Every commercial bank is required by law to maintain a minimum percentage of its deposits with the central bank. The minimum amount of reserve with the central bank may be either a percentage of its time and demand deposits separately or of total deposits. Whatever the amount of money remains with the commercial bank over and above these minimum reserves is known as the excess reserves. It is on the basis of these excess reserves that the commercial bank is able to create credit. The larger the size of the excess reserves, the greater is the power of a bank to create credit, and vice versa. It can also be said that the larger the required reserve ratio, the lower the power of a bank to create credit, and vice versa.

When the central bank raises the reserve ratio of the commercial banks, it means that the latter are required to keep more money with the former. Consequently, the excess reserves with the commercial banks are reduced and they can lend less than before.

On the contrary, if the central bank wants to expand credit, it lowers the reserve ratio so as to increase the credit creation power of the commercial banks. Thus by varying the reserve ratio of the commercial banks the central bank influences their power of credit creation and thereby controls credit in the economy.

4. Selective Credit Controls

Selective or qualitative methods of credit control are meant to regulate and control the supply of credit among its possible users and uses. They are different from quantitative or general methods which aim at controlling the cost and quantity of credit. Unlike the general instruments, selective instruments do not affect the total amount of credit but the amount that is put to use in a particular sector of the economy. The aim of selective credit controls is to channelize the flow of bank credit from speculative and other undesirable purposes to socially desirable and economically useful uses. They also restrict the demand for money by laying down certain conditions for borrowers. They therefore, embody the view that the monopoly of credit should in fact become a discriminating monopoly.

Prof. Chandler defines selective credit controls as those measures that would influence the allocation of credit, at least to the point of decreasing the volume of credit used for selected purposes without the necessity of decreasing the supply and raising the cost of credit for all purposes: We discuss below the main types of selective credit controls generally used by the central banks in different countries.

(A) Regulation of Margin Requirements

This method is employed to prevent excessive use of credit to purchase or carry securities by speculators. The central bank fixes minimum margin requirements on loans for purchasing or carrying securities. They are, in fact, the percentage of the value of the security that cannot be borrowed or lent. In other words, it is the

maximum value of loan which a borrower can have from the banks on the basis of the security (or collateral). For example, if the central bank fixes a 10% margin on the value of a security worth Br 1,000, then the commercial bank can lend only Br 900 to the holder of the security and keep Br 100 with it. If the central bank raises the margin to 25%, the bank can lend only Br 750 against a security of Br 1,000. If the central bank wants to curb speculative activities, it will raise the margin requirements. On the other hand, if it wants to expand credit, it reduces the margin requirements.

(B) Regulation of Consumer Credit

This is another method of selective credit control which aims at the regulation of consumer installment credit or hire-purchase finance. The main objective of this instrument is to regulate the demand for durable consumer goods in the interest of economic stability. The central bank regulates the use of bank credit by consumers in order to buy durable consumer goods on installments and hire purchase.

(C) Rationing of Credit

Rationing of credit is another selective method of controlling and regulating the purpose for which credit is granted by the commercial banks. It is generally of four types. The first is the variable portfolio ceiling. According to this method, the central bank fixes a ceiling on the aggregate portfolios of the commercial banks and they cannot advance loans beyond this ceiling.

The second method is known as the variable capital assets ratio. This is the ratio which the central bank fixes in relation to the capital of a commercial bank to its total assets. In keeping with the economic exigencies, the central bank may raise or lower the portfolio ceiling, and also vary the capital assets ratio. Thirdly, the technique also involves discrimination against larger banks because it restricts their lending power more than the smaller banks. Finally, by rationing of credit for selective purposes, the central bank ceases to be the lender of the last resort. Therefore, central banks in mixed economies do not use this technique except under extreme inflationary situations and emergencies.

(D) Direct Action

Central banks in all countries frequently resort to direct action against commercial banks. Direct action is in the form of "directives" issued from time to time to the commercial banks to follow a particular policy which the central bank wants to enforce immediately. This policy may not be used against all banks but against erring banks. For example, the central bank refuses rediscounting facilities to certain banks which may be granting too much credit for speculative purposes, or in excess of their capital and reserves, or restrains them from granting advances against the collateral of certain commodities, etc. It may also charge a penal rate of interest from those banks which want to borrow from it beyond the prescribed limit. The central bank may even threaten a commercial bank to be taken over by it in case it fails to follow its policies and instructions.

(E) Moral Suasion

Moral suasion is the method of persuasion, of request, of informal suggestion, and of advice to the commercial bank usually adopted by the central bank. The executive head of the central bank calls a meeting of the heads of the commercial banks wherein he explains them the need for the adoption of a particular monetary policy in the context of the current economic situation, and then appeals to them to follow it.

(F) Publicity

The central bank also uses publicity as an instrument of credit control. It publishes weekly or monthly statements of the assets and liabilities of the commercial bank for the information of the public. It also publishes statistical data relating to money supply, prices, production and employment, and of capital and money market, etc. This is another way of exerting moral pressure on the commercial bank. The aim is to make the public aware of the policies being adopted by the commercial bank vis-a-vis the central bank in the light of the prevailing economic conditions in the country.

Monetary Policy and Its Objectives

Monetary policy refers to the credit control measures adopted by the central bank of a country. Johnson defines monetary policy as policy employing central bank's control of the supply of money as an instrument for achieving the objectives of general economic policy. G.K. Shaw defines it as "any conscious action undertaken by the monetary authorities to change the quantity, availability or cost of money.

Objectives of Monetary Policy

The following are the principal objectives of monetary policy.

1. Full Employment

Full employment has been ranked among the foremost objectives of monetary policy. It is an important goal not only because unemployment leads to wastage of potential output, but also because of the loss of social standing and self-respect. Moreover, it breeds poverty.

According to Keynes, full employment means the absence of involuntary unemployment. In other words, full employment is a situation in which everybody who wants to work, gets work. Full employment so defined is consistent with frictional and voluntary unemployment. To achieve full employment, Keynes advocated increase in effective demand to bring about reduction in real wages. Thus the problem of full employment is one of maintaining adequate effective demand.

Keynes gave an alternative definition of full employment at another place in his *General Theory* thus: "It is a situation in which aggregate employment is inelastic in response to an increase in the effective demand for its output." It means that the test of full employment is when any further increase in effective demand is not accompanied by any increase in output. Since the supply of output becomes inelastic at the full employment level, any further increase in effective demand will lead to inflation in the economy. Thus the Keynesian concept of full employment involves

three conditions: (i) reduction in the real wage rate; (ii) increase in effective demand; and (iii) inelastic supply of output at the level of full employment.

According to Professor W.W. Hart attempting to define full employment raises many people's blood pressure, rightly so because there is hardly any economist who does not define it in his own way. Lord Beveridge in his book *Full employment in a Free Society* defined it as a situation where there were more vacant jobs than unemployed men so that the normal lag between losing one job and finding another will be very short. By full employment he does not mean zero unemployment which means that full employment is not always full. There is always a certain amount of frictional unemployment in the economy even when there is full employment. He estimated frictional unemployment of 3% in a full employment situation for England. But his pleading for more vacant jobs than the unemployed cannot be accepted as the full employment level.

According to the American Economic Association Committee, Full employment is a situation where all qualified persons who want jobs at current wage rate find full time jobs. It does not mean unemployment is zero. Here again, like Beveridge, the Committee considered full employment to be consistent with some amount of unemployment. Individual economists may, however, continue to differ over the definition of full employment, but the majority has veered round the view expressed by the U.N. experts on *National and International Measures for Full Employment* that "full employment may be considered as a situation in which employment cannot be increased by an increase in effective demand and unemployment does not exceed the minimum allowances that must be made for the effects of frictional and seasonal factors." This definition is in keeping with the Keynesian and Beveridgian views on full employment. It is now agreed that full employment stands for 96 to 97 per cent employment, with 3 to 4 per cent unemployment existing in the economy due to frictional factors. Full employment can be achieved in an economy by following an expansionary monetary policy.

2. Price Stability

One of the policy objectives of monetary policy is to stabilize the price level. Both economists and laymen favor this policy because fluctuations in prices bring uncertainty and instability to the economy. Rising and falling prices are both bad because they bring unnecessary loss to some and undue advantage to others. Again, they are associated with business cycles. So a policy of price stability keeps the value of money stable, eliminates cyclical fluctuations, brings economic stability, helps in reducing inequalities of income and wealth, secures social justice and promotes economic welfare.

However, there are certain difficulties in pursuing a policy of stable price level. The first problem relates to the type of price level to be stabilized. Should the relative or general price level be stabilized? Wholesale or retail of consumer goods? Or producer goods? There are no specific criteria with regard to choice of a price level. The compromise solution would be to stabilize a price level which would include

consumers' goods prices as well as wages. But this will necessitate increase in the quantity of money but not by as much as is implied in the stabilization of consumers' goods price.

Second innovations may reduce the cost of production but a policy of stable prices may bring larger profits to producers at the cost of consumers and wage earners. Again, in an open economy which imports raw materials and other intermediate products at high prices, the cost of production of domestic goods will rise. But a policy of stable prices will reduce profits and retard further investment. Under these circumstances, a policy of stable prices is not only inequitable but also conflicts with economic progress.

Despite these drawbacks, the majority of economists favor a policy of stable prices. But the problem is one of defining price stability. Price stability does not mean that prices remain unchanged indefinitely. Comparative prices will change as fluctuating tastes alter the composition of demand, as new products are developed and as cost reducing technologies are introduced. Differential price changes are essential for allocating resources in the market economy.

Price stability means *"stability of some appropriate price index in the sense that we can detect no definite upward trend in the index after making proper allowance for the upward bias inherent in all price indexes:"* Price stability can be maintained by following a counter-cyclical monetary policy, that is easy monetary policy during a recession and dear monetary policy during a boom.

3. Economic Growth

One of the most important objectives of monetary policy in recent years has been the rapid economic growth of an economy. Economic growth is defined as *"the process whereby the real per capita income of a country increases over a long period of time."* Economic growth is measured by increase in the amount of goods and services produced in a country. A growing economy produces more goods and services in each successive time period. Thus, growth occurs when an economy's productive capacity increases which, in turn, is used to produce more goods and services. In its wider aspect, economic growth implies the standard of living of the people, and reducing inequalities of income distribution. All agree that economic growth is a desirable goal for a country. But there is no agreement over "the magic number," i.e., the annual growth rate which an economy should attain.

Generally, economists believe in the possibility of 'continual growth. This belief is based on the presumption that innovations tend to increase productive technologies of both capital and labor over time. But there is very likelihood that an economy might not grow despite technological innovations. Production might not increase further due to the lack of demand which may retard the growth of the productive capacity of the economy. The economy may not grow further if there is no improvement in the quality of labor in keeping with the new technologies.

However, policy makers do not take into consideration the costs of growth. Growth is not limitless because resources are scarce in every economy. All factors have opportunity cost. To produce more of one particular product will mean reduction in that of the other. New technologies lead to the replacement of old machines which become useless. Workers are also displaced because they cannot be fitted in the new technological set up immediately. Moreover, rapid growth leads to urbanization and industrialization with their adverse effects on the pattern of living and environment. People have to live in squalor and slums. The environment becomes polluted. Social tensions develop. "But growth has other more basic effect on our environment, and, today, people are not so sure that unrestricted growth is worth all its costs, since the price in terms of change in, deterioration of, or even destruction of the environment is not yet fully known.

What does seem clear, however, is that growth is not going to be halted because of environmental problems and that mankind must learn to cope with the problem or face the consequences. The main problem is to what extent monetary policy can lead to the growth of the economy? It is difficult to say anything definite on this issue. The monetary authority may influence growth by controlling the real interest rate through its effects on the level of investment. By following an easy credit policy and lowering interest rates, the level of investment can be raised which promotes economic growth. Monetary policy may also contribute towards growth by helping to maintain stability of income and prices. By moderating economic fluctuations and avoiding deep depressions, monetary policy helps in achieving the growth objective. Since rapid and variable rates of inflation discourage investment and adversely affect growth, monetary policy helps in controlling hyper-inflation.

Similarly, by a judicious monetary policy which encourages investment, growth can be promoted. For example, tight monetary policy affects small firms more than large firms, and higher interest rates have a greater impact on small investments than on large industrial investments. So monetary policy should encourage investment and at the same time controls hyper-inflation so as to promote growth and control economic fluctuations.

4. Balance of Payments

Another objective of monetary policy since the 1950s has been to maintain equilibrium in the balance of payments. The achievement of this goal has been necessitated by the phenomenal growth in the world trade as against the growth of international liquidity. It is also recognized that deficit in the balance of payments will retard the attainment of other objectives. This is because a deficit in the balance of payments leads to a sizeable outflow of gold. But "it is not clear what constitutes a satisfactory balance of payments position.

Clearly a country with a net debt must be at a surplus to repay the debt over a reasonably short period of time. Once any debt has been repaid and an adequate

reserve attained, a zero balance maintained over time would meet the policy objective. But how is this satisfactory balance to be achieved on the trading account or on the capital account? The capital account must be looked upon as fulfilling merely a short-term emergency role in times of crises."

Again, another problem relates to the question: What is the balance of payments target of a country? It is where imports equal exports. But, in practice, a country whose current reserves of foreign exchange are inadequate will have a mild export surplus as its balance of payments target. But when its reserves become satisfactory, it will aim at the equality of imports and exports. This is because an export surplus means that the country is accumulating foreign exchange and it is producing more than it is consuming. This will lead to low standard of living of the people. But this cannot last long because some other country must be having import surplus and in order to avoid it, it would impose trade restrictions on the export surplus country. So the attainment of balance of payments equilibrium becomes an imperative goal of monetary policy in a country.

How can monetary policy achieve it? A balance of payments deficit is defined as equal to the excess of money supply through domestic credit creation over extra money demand based on increased demand for cash balances. Thus a balance of payments deficit reflects excessive money supply in the economy. As a result, people exchange their excess money holdings for foreign goods and securities. Under a system of fixed exchange rates, the central bank will have to sell foreign exchange reserves and buy the domestic currency for eliminating excess supply of domestic currency. This is how equilibrium will be restored in the balance of payments.

On the other hand, if the money supply is below the existing demand for money at the given exchange rate, there will be a surplus in the balance of payments. Consequently, people acquire the domestic currency by selling goods and securities to foreigners. They will also seek to acquire additional money balances by restricting their expenditure relatively to their income. The central bank, on its part, will buy excess foreign currency in exchange for domestic currency in order to eliminate the shortage of domestic currency.

Central Banking System in Ethiopia

The National Bank of Ethiopia is the [central bank](#) of [Ethiopia](#). Its headquarters is in the capital city of [Addis Ababa](#). The bank's name is abbreviated to NBE. The bank is active in promoting [financial inclusion](#) policy and is a member of the [Alliance for Financial Inclusion \(AFI\)](#)

History of Banking

The agreement that was reached in 1905 between Emperor Minilik II and Mr. Ma Gillivray, representative of the British owned National Bank of Egypt marked the introduction of modern banking in Ethiopia. Following the agreement, the first bank

called Bank of Abyssinia was inaugurated in Feb.16, 1906 by the Emperor. The Bank was totally managed by the Egyptian National Bank and the following rights and concessions were agreed upon the establishment of Bank of Abyssinia:-

» The capital of the Bank was agreed to be Pound Sterling 500,000 and one-fifth was subscribed and the rest was to be obtained by selling shares in some important cities such as London, Paris and New York.

» The Bank was given full rights to issue bank notes and monitor coins which were to be legal tender and all the profits there from a ruing to the bank and freely exchangeable against gold and silver on cover by the Bank as well as to establish silver coins and abolish the Maria Theresa.

» Land was given to the Bank free of charges & permitted to build offices and warehouses. Government and public funds were to be deposited with the bank and all payments to be made by checks.

» The government promised not to allow any bank to be established in the country within the 50-year concession period.

Within the first fifteen years of its operation, Bank of Abyssinia opened branches in different areas of the country. In 1906 a branch in Harar (Eastern Ethiopia) was opened at the same time of the inauguration of Bank of Abyssinia in Addis Ababa. Another at Dire Dawa was opened two years later and at Gore in 1912 and at Dessie and Djibouti in 1920. Mac Gillivray, the then representative and negotiator of Bank of Egypt, was appointed to be the governor of the new bank and he was succeeded by H Goldie, Miles Backhouse, and CS Collier were in change from 1919 until the Bank's liquidation in 1931.

The society at that time being new for the banking service, Bank of Abyssinia had faced difficulty of familiarizing the public with it. It had also need to meet considerable cost of installation and the costly journeys by its administrative personnel. As a result, despite its monopolistic position, the Bank earned no profit until 1914. Profits were recorded in 1919, 1920 and from 1924 onwards.

Generally, in its short period of existence, Bank of Abyssinia had been carrying out limited business such as keeping government accounts, some export financing and undertaking various tasks for the government. Moreover, the Bank faced enormous pressure for being inefficient and purely profit motivated and reached an agreement to abandon its operation and be liquidated in order to disengage banking from foreign control and to make the institution responsible to Ethiopia's credit needs. Thus by 1931 Bank of Abyssinia was legally replaced by Bank of Ethiopia shortly after Emperor Haile Selassie came to power.

The new Bank, Bank of Ethiopia, was a purely Ethiopian institution and was the first indigenous bank in Africa and established by an official decree on August 29, 1931 with capital of £750,000. Bank of Egypt was willing to abandon its concessionary rights in return for a payment of Pound Sterling 40,000 and the transfer of ownership took place very smoothly and the offices and personnel of the Bank Of Abyssinia including its manager, Mr. Collier, being retained by the new Bank. Ethiopian government owned 60 percent of the total shares of the Bank and all transactions were subject to scrutiny by its Minister of Finance.

Bank of Ethiopia took over the commercial activities of the Bank of Abyssinia and was authorized to issue notes and coins. The Bank with branches in Dire Dawa, Gore, Dessie, Debre Tabor, Harar, agency in Gambella and a transit office in Djibouti continued successfully until the Italian invasion in 1935. During the invasion, the Italians established branches of their main Banks namely Banca d'Italia, Banco di Roma, Banco di Napoli and Banca Nazionale del lavoro and started operation in the main towns of Ethiopia. However, they all ceased operation soon after liberation except Banco di Roma and Banco di Napoli which remained in Asmara. In 1941 another foreign bank, Barclays Bank, came to Ethiopia with the British troops and organized banking services in Addis Ababa, until its withdrawal in 1943. Then on 15th April 1943, the State Bank of Ethiopia commenced full operation after 8 months of preparatory activities. It acted as the central Bank of Ethiopia and had a power to issue bank notes and coins as the agent of the Ministry of Finance. In 1945 and 1949 the Bank was granted the sole right of issuing currency and deal in foreign currency. The Bank also functioned as the principal commercial bank in the country and engaged in all commercial banking activities.

The State Bank of Ethiopia had established 21 branches including a branch in Khartoum, Sudan and a transit office on Djibouti until it ceased to exist by bank proclamation issued on December, 1963. Then the Ethiopian Monetary and Banking law that came into force in 1963 separated the function of commercial and central banking creating National Bank of Ethiopia and commercial Bank of Ethiopia. Moreover it allowed foreign banks to operate in Ethiopia limiting their maximum ownership to be 49 percent while the remaining balance should be owned by Ethiopians.

The National Bank of Ethiopia with more power and duties started its operation in January 1964. Following the incorporation as a share company on December 16, 1963 as per proclamation No.207/1955 of October 1963, Commercial Bank of Ethiopia took over the commercial banking activities of the former State Bank of Ethiopia. It started operation on January 1, 1964 with a capital of Eth. Birr 20 million. In the new Commercial Bank of Ethiopia, in contrast with the former State Bank of Ethiopia, all employees were Ethiopians.

There were two other banks in operation namely Banco di Roma S. and Bank di Napoli S.C. that later reapplied for license according to the new proclamation each having a paidup capital of Eth. Birr 2 million.

The first privately owned bank, Addis Ababa Bank share company, was established on Ethiopians initiative and started operation in 1964 with a capital of 2 million in association with National and Grindlay Bank, London which had 40 percent of the total share. In 1968, the original capital of the Bank rose to 5.0 million and until it ceased operation, it had 300 staff at 26 branches.

There were other financial institutions operating in the country like the Imperial Savings and Home Ownership public Association (ISHOPA) which specialized in providing loans for the construction of residential houses and to individuals under the guarantee of their savings. There was also the Saving and Mortgage Corporation of Ethiopia whose aims and duties were to accept savings and trust deposits account and provide loans for the construction, repair and improvement of residential houses, commercial and industrial buildings and carry out all activities related to mortgage operations. On the other hand, there was a bank called Agricultural Bank that provides loan for the agricultural and other relevant projects established in 1945. But in 1951 the Investment Bank of Ethiopia replaced it. In 1965, the name of the bank once again hanged to Ethiopian Investment Corporation Share Company and the capital raised to Eth. Birr 20 million, which was fully paid up. However, proclamation No.55 of 1970 established the Agricultural and Industrial Development Bank Share Company by taking over the asset and liability of the former Development Bank and Investment Corporation of Ethiopia.

Following the declaration of socialism in 1974 the government extended its control over the whole economy and nationalized all large corporations. Organizational setups were taken in order to create stronger institutions by merging those that perform similar functions. Accordingly, the three private owned banks, Addis Ababa Bank, Banco di Roma and Banco di Napoli Merged in 1976 to form the second largest Bank in Ethiopia called Addis Bank with a capital of Eth. birr 20 million and had a staff of 480 and 34 branches. Before the merger, the foreign participation of these banks was first nationalized in early 1975. Then Addis Bank and Commercial Bank of Ethiopia S.C . were merged by proclamation No.184 of August 2, 1980 to form the sole commercial bank in the country till the establishment of private commercial banks in 1994. The Commercial Bank of Ethiopia commenced its operation with a capital of Birr 65 million, 128 branches and 3,633 employees. The Savings and Mortgage Corporation S.C . and Imperial Saving and Home Ownership Public Association were also merged to form the Housing and Saving Bank with working capital of Birr 6.0 million and all rights, privileges, assets and liabilities were transferred by proclamation No.60, 1975 to the new bank.

Proclamation No.99 of 1976 brought into existence the Agricultural and Industrial Bank, which was formed in 1970 as a 100 percent state ownership, was brought under the umbrella of the National Bank of Ethiopia. Then it was reestablished by proclamation No. 158 of 1979 as a public finance agency possessing judicial personality and named Agricultural and Industrial Development Bank (AIDB). It was entrusted with the financing of the economic development of the agricultural, industrial and other sectors of the national economy extending credits of medium and long-term nature as well as short-term agricultural production loans.

The financial sector that the socialist oriented government left behind constituted only 3 banks and each enjoying monopoly in its respective market. The following was the structure of the sector at the end of the era.

- 🚩 The National Bank of Ethiopia (NBE)
 - o The Commercial Bank of Ethiopia (CBE)
 - o Agricultural and Industrial Development Bank (AIDB)

Following the demise of the Dergue regime in 1991 that ruled the country for 17 years under the rule of command economy, the EPRDF declared a liberal economy system. In line with this, Monetary and Banking proclamation of 1994 established the national bank of Ethiopia as a judicial entity, separated from the government and outlined its main function.

Monetary and Banking proclamation No.83/1994 and the Licensing and Supervision of Banking Business No.84/1994 laid down the legal basis for investment in the banking sector. Consequently shortly after the proclamation the first private bank, Awash International Bank was established in 1994 by 486 shareholders and by 1998 the authorized capital of the Bank reached Birr 50.0 million. Dashen Bank was established on September 20,1995 as a share company with an authorized and subscribed capital of Birr 50.0 million. 131 shareholders with subscribed and authorized capital of 25.0 million and 50 million founded bank of Abyssinia. Wegagen Bank with an authorized capital of Birr 60.0 million started operation in 1997. The fifth private bank, United Bank was established on 10th September 1998 by 335 shareholders. Nib International Bank that started operation on May 26, 1999 with an authorized capital of Birr 150.0 million. Cooperative Bank of Oromia was established on October 29,2004 with an authorized capital of Birr 22.0 million. Lion International Bank with an authorized capital of Birr 108 million started operation in October 02,2006. Zemen Bank that started operation on June 17, 2008 with an authorized capital of Birr 87.0 million. The last bank to be established to date is Oromia International Bank that started operation on September 18, 2008 with an authorized capital of Birr 91 million.

Commercial Banking

Definition of Commercial Banking

Chamber's Twentieth Century Dictionary defines a bank as an "institution for the keeping, lending and exchanging, etc. of money." Economists have also defined a bank highlighting its various functions. According to Crowther, "The banker's business is to take the debts of other people to offer his own in exchange, and thereby create money." A similar definition has been given by Kent who defines a bank as "an organization whose principal operations are concerned with the accumulation of the temporarily idle money of the general public for the purpose of advancing to others for expenditure." Sayers, on the other hand, gives a still more detailed definition of a bank thus: "Ordinary banking business consists of changing cash for bank deposits and bank deposits for cash; transferring bank deposits from one person or corporation (one 'depositor') to another; giving bank deposits in exchange for bills of exchange, government bonds, the secured or unsecured promises of businessmen to repay, etc." Thus a bank is an institution which accepts deposits from the public and in turn advances loans by creating credit. It is different from other financial institutions in that they cannot create credit though they may be accepting deposits and making advances.

Commercial Banking Services

Commercial banks perform a variety of functions which can be divided as: 1) accepting deposits; (2) advancing loans; (3) credit creation; (4) financing foreign trade; (5) agency services; and (6) miscellaneous services to customers. These functions are discussed as follows:

(1) Accepting Deposits

This is the oldest function of a bank and the banker used to charge a commission for keeping the money in its custody when banking was developing as an institution. Nowadays a bank accepts three kinds of deposits from its customers. The first is the *savings* deposits on which the bank pays small interest to the depositors who are usually small savers. The depositors are allowed to draw their money by cheques up to a limited amount during a week or year. Businessmen keep their deposits in *current* accounts. They can withdraw any amount standing to their credit in current deposits by cheques without notice. The bank does not pay interest on such accounts but instead charges a nominal sum for services rendered to its customers.

Current accounts are known as demand deposits. Deposits are also accepted by a bank in *fixed* or *time* deposits. Savers who do not need money for a stipulated period from months to longer periods ranging up to 10 years or more are encouraged to keep it in fixed deposit accounts. The bank pays a higher rate of interest on such deposits. The rate of interest increases with the length of the time period of the fixed deposit. But there is always the maximum limit of the interest rate which can be paid.

(2) Advancing Loans

One of the primary functions of a commercial bank is to advance loans to its customers. A bank lends a certain percentage of the cash lying in deposits on a higher interest rate than it pays on such deposits. This is how it earns profits and carries on its business. The bank advances loans in the following ways:

(a) *Cash Credit*. The bank advances loans to businessmen against certain specified securities. The amount of the loan is credited to the current account of the borrower. In case of a new customer a loan account for the sum is opened. The borrower can withdraw money through cheques according to his requirements but pays interest on the full amount.

(b) *Call Loans*. These are very short-term loans advanced to the bill brokers for not more than fifteen days. They are advanced against first class bill of securities. Such loans can be recalled at a very short notice. In normal times they can also be renewed.

(c) *Overdraft*. A bank often permits a businessman to draw cheques for a sum greater than the balance lying in his current account. This is done by providing the overdraft facility up to a specific amount to the businessman. But he is charged interest only on the amount by which his current account is actually overdrawn and not by the full amount of the overdraft sanctioned to him by the bank.

(d) *Discounting bills of Exchange*. If a creditor holding a bill of exchange wants money immediately, the bank provides him the money by discounting the bill of exchange. It deposits the amount of the bill in the current account of the bill-holder after deducting its rate of interest for the period of the loan which is not more than 90 days. When the bill of exchange matures, the bank gets its payment from the banker of the debtor who accepted the bill.

(3) Credit Creation

Credit creation is one of the most important functions of the commercial banks. Like other financial institutions, they aim at earning profits. For this purpose, they accept deposits and advance loans by keeping small cash in reserve for day-to-day transactions. When a bank advances a loan, it opens an account in the name of the customer and does not pay him in cash but allows him to draw the money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.

(4) Financing Foreign Trade

A commercial bank finances foreign trade of its customers by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and buys and sells foreign currency.

(5) Agency Services

A bank acts as an agent of its customers in collecting and paying cheques, bills of exchange, drafts, dividends, etc. It also buys and sells shares, securities, debentures, etc. for its customers. Further, it pays subscriptions, insurance premia, rent, electric and water bills, and other similar charges on behalf of its clients. It also acts as a trustee and executor of the property and will of its customers. Moreover, the bank acts as an income tax consultant to its clients. For some of these services, the bank charges a nominal fee while it renders others free of charge.

(6) Miscellaneous Services

Besides the above noted services, the commercial bank performs a number of other services. It acts as the custodian of the valuables of its customers by providing them

lockers where they can keep their jewelry and valuable documents. It issues various forms of credit instruments, such as cheques, drafts, travellers' cheques, etc. which facilitate transactions. The bank also issues letters of credit and acts as a referee to its clients. It underwrites shares and debentures companies and helps in the collection of funds from the public. Some commercial banks also publish journals which provide statistical information about the money market and business trends of the economy.

Essentials of a Sound Banking System

The essentials of a sound banking system are usually regarded as liquidity and profitability. As pointed out by Crowther, the secret of successful banking is to distribute resources between the various forms of assets in such a way as to get a sound balance between liquidity and profitability, so that there is cash (on hand or quickly realizable) to meet every claim, and at the same time enough income for the bank to pay its way and earn profits for its shareholders. But modern bankers also consider a few other essentials which are discussed below.

1. Liquidity

One of the essentials of a sound banking system is to have a high degree of liquidity. The bank holds a small proportion of its assets in cash. Therefore, its other assets must possess the criterion of liquidity so that they may be turned into such easily. A commercial bank is under an obligation to pay its depositors cash on demand. This is only possible if the bank possesses such securities which can be easily liquidated. Central banks have made it obligatory on the commercial banks to keep a certain proportion of their assets in cash to ensure liquidity.

2. Safety

Another essential of a sound banking system is that it must be safe. Since the bank keeps the deposits of the people, it must ensure the safety of their money. So it should make safe loans and investments and avoid unnecessary risks. If the debtors of the bank do not repay the loans in time and it loses on its investments, the bank shall become insolvent. As a result, its depositors lose money and suffer hardships. Thus the bank must ensure the safety of its deposits.

3. Stability

A sound banking system must be stable. It should operate rationally. There should neither be undue contraction nor expansion of credit. If the bank restricts the creation of credit when trade and industry need it the most, it will harm the interests of the business community. On the other hand, if it expands credit when the economic conditions do not permit, it will lead to boom and inflation. So the banking system should follow a stable lending policy. The central bank of the country can help in achieving stability in the banking operations of the commercial banks by a judicious credit control policy.

4. Elasticity

The stability of banking operations should not be interpreted as rigidity. Rather, the banking system should have sufficient elasticity in its lending operations. It should be

in a position to expand and contract the supply of loanable funds with ease in accordance with the directives of the central bank of the country.

5. Profitability

A sound banking system should be able to earn sufficient profits. Profits are essential for it to be viable. It has to pay the corporation tax like any other company, pay interest to its depositors, dividend to shareholders, salaries to the staff and meet other expenses. So unless the bank earns, it cannot operate soundly. For this purpose, it must adopt judicious loan and investment policies.

6. Reserve Management

Sound banking system must follow the principle of efficient reserve management. A bank keeps some amount of money in reserve for meeting the demand of its customers in case of emergency. Though the money kept in reserve is idle money, yet the bank cannot afford the risk of keeping a small amount in reserve. There are, however, some statutory limits laid down by the central bank in maintaining minimum reserves with itself and with the bank. But how much reserve money should a bank maintain is governed by its own wisdom, experience and the size of the bank. The bank should manage its reserve policy effectively and efficiently without keeping too much or too little cash. It has to balance between profitability and safety.

7. Expansion

A sound banking system must be spread throughout the country. It should not be concentrated only in big towns and cities but in rural areas and backward regions. It is only by widespread expansion of the banking system that the deposits can be mobilized and credit facilities can be made available to trade, industry agriculture, etc. This is especially the case in a developing country where the banking system must provide these facilities through its expansion in all areas. This is essential for capital formation and economic growth.

Domestic and International Banking

1. Domestic Banking in Ethiopia (Commercial Banking system)

Commercial Bank of Ethiopia extends various types of loans and advances to the following business sectors:

Domestic trade	Hotel and tourism	Transport
Import and export trade	Manufacturing	Services (education, health, etc), and
Agriculture	Construction	Others.

Acceptable collaterals to the bank are:

Buildings/Houses

The buildings/houses should be constructed within the city's limits; and They can be used for residential purposes, as warehouses or business organizations.

Motor vehicles

This includes trucks, tankers, trailers, combiners, public transport, buses and automobiles

Merchandise (for merchandise loan only).

The merchandise should be:

Easily marketable

Non-perishable items.

Durable and

Negotiable Instruments

Treasury bills

Leased land

Business mortgage.

Government bonds

Machinery and
agricultural equipment

Interest

At present, CBE collects a 7.5% interest rate per annum on credit facilities it extends.

The CBE may vary the interest rate based on the Directive of the National Bank of Ethiopia.

In addition, as per the new Credit Policy, the Bank's customers may be charged various interest rates based on their:

Loan repayment history

Collateral strength and

Business strength

Other similar factors.

That is, customers who meet the Bank's performance parameters are charged less interest rate, whereas the Bank will impose an additional 3% penalty interest rate per annum on non-performing loans.

Documents required from customers during loan request

A written application that clearly indicates, among others, the amount and the purpose of the loan requested.

Licenses (as appropriate)

Trade and industry license specific to the line of activity and renewed for the current operational year.

Municipal license Registration certificate

Investment license Others as applicable.

Financial statements (audited as deemed necessary)

Balance sheet

Income statement

Cash-flow statement

If the customer cannot prepare the financial statements and the requested loan amount is small, he/she has to fill out the Commercial Credit Report (CCR) form, which will be provided by the Bank, and Others.

A business plan : A project feasibility study (for new projects)

In addition, if the requested loan is approved, customers must meet the following conditions:

- ✚ The borrower and the guarantor must sign loan and pledge contracts.
- ✚ The collateral offered as security must be insured both in the names of the Bank and the borrower.
- ✚ The borrower must be willing to register the collateral with the appropriate government body.
- ✚ The borrower has to open a deposit account at the concerned branch, if he/she has not done so, as specified under each type of credit services.

Types of Credit Facilities

Currently, the Commercial Bank of Ethiopia (CBE) offers the following credit products: Term Loan

- ✓ A term loan is a loan granted to customers to be repaid with interest within a specific period of time.
- ✓ The loan can be repaid in periodic installments or in a lump sum on the due date of the loan, as the case may be.
- ✓ This loan is granted in three forms, i.e., short-term, medium-term and long-term loan.
- ✓ A short-term loan is a loan that has a maturity period of one year or twelve months from the date the loan contract is signed.

Purpose of the loan

- ✓ The loan is extended to finance the working capital needs and/or to meet other short-term financial constraints of customers.

Eligibility

- ✓ Applicants can be individuals and business entities engaged in any type of business that can meet the following conditions:
- ✓ The client must have been in the business for which the loan is requested or in a related business for at least one year with a permanent address.
- ✓ The applicant needs to have opened an account at the branch where the loan is requested.
- ✓ The applicant has to present the necessary documents required by the Bank.
- ✓ The applicant must not have any record of default and misuse of his checking account in the banking system.

Collateral

- ✓ The security offered must be able to cover both the principal and the interest of the loan.
- ✓ Repayment of the loan
- ✓ The loan can be repaid monthly, quarterly, semi-annually or annually in a lump sum upon maturity, depending on the nature of the business and cash-flow statement.
- ✓ The periodic repayment amount incorporates both principal and interest.

Medium- and Long-term Loan (project loan)

- ✓ A medium-term loan is a loan which has a maturity period exceeding one year but less than or equal to five years from the date the loan contract is signed.
- ✓ A long-term loan is a loan that has a maturity period of five to fifteen years.
- ✓ The purpose of the loan is to finance new projects, support the expansion of existing projects, investments and meet working capital needs.

Eligibility

- ✓ Applicants can be either new or existing customers. To be eligible for the loan, customers must present the following:
- ✓ For new projects : A feasibility study

- ✓ Lease agreement and certificate, land holding-certificate and bill of quantity and specification (if the project involves construction)

2. International Banking

No review of the international financial system would be complete without a discussion of the role of international banking institutions. Through these banking firms flow the majority of commercial and financial transactions that cross international borders. Commercial banking institutions have led in the development of international banking facilities to meet the far-flung financial needs of foreign governments and multinational corporations.

The development of multinational banking over the past century has resulted in several benefits for international trade. One benefit to the public is greater competition in international markets, lowering the real prices of financial services. It also has tied together more effectively the various national money markets into a unified international financial system, permitting a more efficient allocation of the world's scarce resources. Funds flow relatively freely today across national boundaries in response to differences in relative interest rates and currency values. Although these developments have benefited both borrowers and investors, they also have created problems for governments trying to regulate *the volume* of credit, insure a stable banking system, and combat inflation.

The Scope of International Banking Activities

Multinational Banking Corporations

The term **multinational corporation** usually is reserved for large nonfinancial corporations with manufacturing or trading operations in several different countries. However, this term is equally applicable to the world's leading banks, most of which have their home offices in Canada, the United States, Great Britain, Germany, France, Spain, and Japan but have established offices worldwide. These giant banks have accounted for most of the growth in multinational banking in recent decades.

Types of Facilities Operated by Banks Abroad

Major banks around the world have used many vehicles to expand their international operations. All major banks have *international*

departments in their home offices to provide credit, access to foreign currencies, and other services for their international customers, and many operate full-service *branch offices* in foreign markets as well. *Others* maintain simple booking offices, known as **shell branches** to attract Eurocurrency accounts *while avoiding domestic banking* regulations. **Representative offices** help find new customers and give local customers a point of contact with the home office, but they cannot take deposits. Many banking firms have also set up **international banking facilities** (IBFs), consisting of computerized accounts maintained for international customers. **Agency offices** provide specialized services, such as recordkeeping for business transactions and providing customers with liquid balances for spending as needed. In addition, multinational banks often make *direct equity investments* in foreign companies either alone or as *joint ventures* with other financial firms.

Choosing the Right Kind of Facility to Serve Foreign Markets

Which kind of facility is adopted by a multinational bank to serve its customers depends on government regulations and the bank's size, goals, and location. Most banks begin with international department in their home offices and then, as the volume of business grows, open up representative offices. Ultimately, full-service branches and investments in foreign businesses may be established. A recent trend toward legal liberalization of foreign trade and international lending has stimulated the growth of *home-based offices* that send officers to call on customers overseas or serve clients by satellite, the Internet, and other electronic channels. However, many multinational banks argue that successful international operations require an institution to have stable presence overseas in the form of agencies, branches, representative offices, or even joint ventures with other banks.

Laws and regulations play a major role in determining the nature and location of multinational banking offices. For example, in some areas of the world, such as the Middle East, fears of political upheaval or outright expropriation of foreign-owned facilities have limited the entry of multinational banks.

Services Offered by International Banks

Multinational banks offer a wide variety of international financial services to customers. These services are described briefly below. Of

course, the particular services offered by each bank depend on its size, location, the types of facilities it maintains overseas, and the regulations it faces.

1. Issuing Letters of Credit

Most banks enter the international sector initially to finance trade. In most cases, credit is needed to bridge the gap between cash expenditures and cash receipts and to reduce the risks associated with long-distance trading. In these situations, a letter of credit is often the ideal financing instrument.

A letter of credit (LC) is an international bank's future promise to pay for goods stored overseas or for goods shipped between countries. Such letters may be issued to finance exports and imports or to provide a standby guarantee of payment behind IOUs issued by a corporate customer. Through a letter of credit, the bank substitutes its own promise to pay for the promise of one of its customers. By substituting its promise, the bank reduces the seller's risk, facilitating the flow of goods and services through international markets.

Occasionally, the seller becomes concerned about the soundness of the bank issuing the letter of credit. The seller may then ask his or her own bank to issue a *confirmation letter* in which that bank guarantees against foreign bank default.

IOU (I owe you) is a written promise that you will pay somebody the money you owe them.

2. Buying and Selling Foreign Exchange (FOREX)

Major multinational banks have dealer departments that specialize in trading foreign currencies (FOREX). International banks buy and sell foreign currencies on a 24-hour basis to support the import and export of goods and services, the making of investments, the giving of gifts, and the financing of tourism. They also write forward contracts for the future delivery of foreign exchange.

3. Accepting Eurocurrency Deposits and Making Eurocurrency Loans

International banks accept deposits denominated in currencies other than that of their home country. These Eurocurrency deposits are used to pay for goods shipped between countries and serve as a source of loanable funds for banks. Eurocurrency deposits also may be loaned to corporations and other large wholesale borrowers. Eurocurrency credit normally goes to borrowers with impeccable

credit ratings. One important innovation is the *syndicated Eurocurrency credit*, in which one or more multinational banks will put together a loan package accompanied by an information memorandum. Other banks can then participate in the loan without direct communication with the borrower.

4. Marketing and Underwriting of Both Domestic and Eurocurrency Bonds, Notes, and Equity Shares

For generations, leading international banks have assisted their customers in raising capital through the issuance of new securities—bonds and other forms of debt and equity shares. One of the most well-known of these securities is the Eurobond—a debt security denominated in a currency other than that of the country or countries where most or all of the security is sold. For example, a U.S. automobile company may desire to float an issue of long-term bonds to raise capital for one of its subsidiaries operating in Greece. The company might issue bonds denominated in British pounds to be sold in Europe through an underwriting syndicate made up of banks and securities dealers. Alternatively, the borrowing company might issue bonds denominated in euros, which is now the largest corporate bond market in the world.

Multinational banks also assist their corporate and governmental customers with medium-term financing through note issuance facilities (NIFs). Under a standard NIF contract, a customer is authorized to issue short-term notes periodically (usually with three to six-month maturities) to interested investors over a designated time span (perhaps five years). The bank or banks involved agree to provide backup funding (standby credit) at a spread over prevailing Euromarket interest rates. For an underwriting fee, the bank agrees to purchase any unsold notes or advance cash to the customers until sufficient market funding is obtained.

5. Securitizing Loans

Securitization is the pooling of loans having similar purposes, quality, and maturities and the selling of financial claims (securities) against the pool of loans. Good examples are New York's Citigroup and JPMorgan Chase, which are among the leading packagers of consumer credit-card receivables, pooling the receivables that arise as households borrow on their credit cards and selling securities in the open market as claims against the income those receivables will ultimately bring in. International banks can earn income in several

different ways from the securitization process: (1) by securitizing some of their own loans and pocketing the difference in interest earnings between the average yield on the pool of loans and the cost of issuing securities against the loan pool; (2) by agreeing to guarantee the income of investors from pools of securitized loans; (3) by retaining servicing rights on a pool of loans, collecting and recording the income received from the loans in return for a servicing fee; or (4) by acting as adviser or trustee for those customers that desire to securitize any loans or receivables they hold in order to generate new capital.

6. Advisory Services Provided by International Banks

In addition to the foregoing services, international banks offer extensive *advisory services* to their customers. These include analyses of foreign market conditions, evaluation of sales prospects and plant location sites, and advice on foreign regulations. International banks prepare credit reports on overseas buyers for exporters of goods and services and assist domestic firms interested in entering foreign markets.

7. Universal Banking Services and One-Stop Shopping

As the foregoing list of service offerings suggests, the world's largest banking firms, such as Citigroup and Deutsche Bank, are reaching out to diversify their services in many different directions, attempting to offer their customers "one-stop shopping" and becoming what European bankers have, for decades, referred to as "universal banks." Universal banking combines traditional banking, insurance, securities trading, real estate brokering, and a long list of other services under one corporate umbrella.

Its alleged advantages include greater stability of revenues (cash flow) and profits, less risk of succumbing to market stress as declines in one service area may be offset by increased revenues from other services, and lower overall fund-raising costs. However, an international banking firm may not be able to manage all of its different service areas efficiently, resulting in lower rates of return and loss of market share.