

CHAPTER - II

CENTRAL BANKING :

The origin of central banking dates back to 1894, when the ‘the Governor and the Company of the Bank of England’, the present day Bank of England, was established, the art of central banking assumed new dimensions only during the 20th century phenomenon. The earlier institutions were, by large, banks of issue with the sole or principal right of note issue. Modern central banking techniques were unknown to them. They were not very different from other existing institutions doing banking business except for the special relations which they had with their respective governments. It was only through a process of trial and error that they come to occupy the pivotal and strategic status which they enjoy in the present day monetary and banking structure.

Even during the beginning of 20th century, many countries were still without central banks. The first world war and the consequent chaotic monetary conditions brought home to these countries the imperative necessity of establishing a centralized institution capable of creating and maintaining equilibrium in the monetary sphere. The International Financial Conference held at Brussels in September 1920 pointed out the urgency of establishing a central bank in those countries which had not yet established a central bank. This conference resolved that in countries where there is no central bank of issue, one should be established. The Genoa Conference, in the spring of 1922, also emphasized the importance of a central bank as an agency to correct the financial disequilibrium and to promote international co-operation in the monetary world.

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 control credit”*.

Hawtrey, *a central bank is that which is the lender of the last resort.*

According to A.C.L. Day, a central bank is *“to help control and stabilise 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 behaviour 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 the words of **DeKock**, ‘central banks have developed their own code of rules and practices, which can be described as *“the art of central banking” but which, in a changing world, is still in the process of evolution and subject to periodical adjustment’.*

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.”

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 governments 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 the currency, deficit financing, balance of payments, etc. As pointed out by De Kock, “Central banks everywhere operate as bankers to the state not only because it may be more convenient and economical to the state, but also because of the intimate connection between public finance and monetary affairs.”

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 banks. 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 centralisation of cash reserves in the central bank is a source of great strength to the banking system of a country. **Secondly**, centralised cash reserves can serve as the basis of a large and more elastic credit structure than if the same amount were scattered among the individual banks. **Thirdly**, centralised cash reserves can be utilised 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 and sells foreign currencies at international prices. Further, it fixes the exchange rates of the 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. It acts as lender of the last resort through discount house on the basis of treasury bills, government securities and bonds at “the front door”.

The other method is to give temporary accommodation to the commercial banks or discount houses directly through the “back door”. The difference between the two methods is that lending at the front door is at the bank rate and in the second case at the market rate. Thus

the central bank as lender of the last resort is a big source of cash and also influences prices and market rates.

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 in big cities and trade centres. 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 economises the use of money. "It is not only a means of economising 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 stabilise economic activity in the country.

Besides the above noted functions, the central banks in a number of developing countries have been entrusted with the responsibility of developing a strong banking system to meet the expanding requirements of agriculture, industry, trade and commerce.

Accordingly, the central banks possess some additional powers of supervision and control over the commercial banks. They are the

- issuing of licences
- the regulation of branch expansion
- to see that every bank maintains the minimum paid up capital and reserves as provided by law

- inspecting or auditing the accounts of banks
- to approve the appointment of chairmen and directors of such banks in accordance with the rules and qualifications
- to control and recommend merger of weak banks in order to avoid their failures and to protect the interest of depositors
- to recommend nationalisation of certain banks to the government in public interest
- to publish periodical reports relating to different aspects of monetary and economic policies for the benefit of banks and the public and
- to engage in research and train banking personnel etc..