为中国人民银行
高级职员开设的
训练计划课程

CENTRAL BANKING

INTRODUCTION

Though the Riks Bank of Sweden created in 1656 is considered to be the first central bank of the World, it is around the Bank of England established in 1694 has the traditions of modern central banking grown. Central bank so familiar to us now has emerged throughout the world during the present century. The Federal Reserve Bank came into esistence as recently as 1914.

A central bank is the supreme monetary authority of a country. It is the apex of a national banking system. It recognized throughout the world that an efficient monetory mechanism is indespensable·to the steady development of a nation's resources and a rising standard of living. Its function is to foster a flow of credit and money that will facilitate orderly economic growth and a strong national currency so as to leive price stability.

In theory, at least, a central bank attempts to direct the flow of credit and money in such a manner so as to carry out its central responsibility. They rely for the purpose on its ability to increase or decrease the availibility, volume, and cost of bank (i.e. the members banks) reserves.

The principal banking methods of bank reserves are purchases and sales of the securities of the national government in the open market. Lending to member banks, and charges the reserve requirements. Where relevant for in country, the central bank's regulation of stock market credit supplements these means of influence. Use of all the instrument is, in theory closely coordinated. The major banks of a country be it indigeneous or foreign, are the members of its central bank.

The national credit market consists of many interdependent markets of which the commercial bank plays a very important role. Developments in various parts of the market interact on and influence other parts. Neither the banking sector nor the non-banking sectors of the market can be understood by themselves.

by themselves/

Price paid for the borrowed money is the interest rate. In theory they are established in credit markets as supplies of and demands for loanable funds seek balance. The interest rates are influenced by a nations saving and investment by market expectations and the flow of bank credit and money. A central banks influence on the flow of bank credit and money affects decisions to lend, spend, and save throughout the economy. Hence the reserve banking policy of a central bank which is of vital importance in directing flow of credit. Contributes to stable economic progress when sensibly pursued. The central bank of a country is responsible providing smooth supply of currency. It pays out currency in response to the demand of the public and absorb the redundant currency.

Supervision of the individual banks by the central bank helps and maintain an adequate and responsible banking system and thus contributes to the smooth functioning of economic process. The weekly statements issued by the central banks of its own affairs and of the member banks indicate the situation of the monetary and the credit market of a country.

The central banks work as a custodian of a nation's foreign exchange reserves. This function is derived from its. Other two functions viz right to issue notes and the custody of the cash reserves of commercial banks. The reserve held by the central banks are used to correct any adverse balance of payments and to maintain the external value of money.

Two of the papers for the course deals with central bank of two differents of economic culture so to say. One is concerned with the Federal Reserve Bank of USA. It is a central bank of a developed economy. Another paper deals in some details about the central banking system of developing countries. The document is structured arround the traditions of the sub-continental central banking.

THE SUB-CONTINENTAL CENTRAL BANKING SYSTEM

FUNCTIONS

The central banks in the sub-continent act as the note issuing authority, banker's bank and banker to the Government, and to promote the growth of the economy within the general framework of the general policy of the Government consistent with the need for maintenance of price stability. The central bank performs a wide range of promotional functions with a view to ensuring the efforts of their respective countries to speed up the process of economic development with social justice in the light of economic planning of the country.

The sub-continental central banks not only rely upon the instruments of general credit control such as bank rate, open market operations and the power to vary the reserve requirements of the member banks, but also enjoy extensive powers of selective and direct credit regulation. The central banks employs the power of moral suasion quite extensively.

They advise the Government on general economic matters and on financial problems in particular. They have an important role to play in the maintenance of the exchange value of the country's currency in view of its importance for the international trade and national economic growth and well being. It enjoys extensive powers of exchange control in conformity with the trade policy of the Government. It also regulates various kinds of transactions in foreign exchange.

The central banks in the sub-continent have special responsibilities about giving support for agricultural credit through the cooperatives and the other banks. It plays significant role in promoting industrial financing activities.

One of the major tasks of the central banks is to build up a sound and adequate banking and credit structure on modern lines. They enjoy extensive powers under the banking laws of their countries to protect the interests of the depositors. They have extensive powers of supervision and control over the member banks, known a scheduled banks in the sub-continent.

the sub-continent/

With wide spread nationalization of banking in the sub-continent in late sixties and the seventies banking policy and branch development policy has been used for the following purposes:-

1. They have been an active agent of economic growth.

2. They attempt to bring about reduction in income inequalities.

3. They try to eliminate concentration of economic power and regional disparities of economic power. As a tool for this they try to bring about fairness in deployment of credit to various groups and regions.

4. Efforts are made to reduce urban rural disparity in distribution of credit.

5. Special attention has been paid in extending credit to the professional sectors and the weaker sections of the country.

It may be noted that all the three countries of the sub-continent carry their economic activities within the framework of economic planning. The central banking in such a context could hardly be confined to overall supply of credit or to somewhat negative regulation of the flow of bank credit. It had to take an active role in creating or helping to create the machinery required for financing development activities all over the country and ensuring that they flow in the directions intended by the respective National Governments.

AS A CURRENCY AUTHORITY

In the sub-continent currency forms a significant part of the money supply even though its importance declined over the years. Since the currency (and the deposit liabilities of the central bank which are as good as currency) constitutes the base for expansion of money supply, regulation of currency is an important element of monetary control.

The assets against which the currency notes are issued have to consist of gold coins and bullion, foreign securities, the local currency securities of any maturity and bills of exchange and promissory notes payable in the country which are eligible for purchase by the central bank.

The proportional reserve system for issue of currency was abandoned from the early fifties. Instead a policy of minimum reserve was pursued, which again was changed from time to time. Purpose of holding the reserve now is to enable the country to absorb the impact of unfavourable movements in the balance of payments rather than to serve as a backing of issue of natinal currency. The proprotional reserve system was a handicap to economic planning, because it did not provide sufficently wide base for monetary expansion. Henceforth credit expansion became the major reason for monetary expansion.

The central bank maintains currency chests all over the country. Where it does not have branches, the chests are maintained by its agent, which is the principal commercial bank of the country and the Government treasuries. Purpose of maintaining currency chests throughout the country is to eliminate as far as possible, the requirement of constant transfers of funds in outlying areas.

The maintenance of currency chests and the remittance facilities provided by the central bank is of great help to Government and the banks in as much as the Treasuries of the Government and the banks can work with fairly nominal balance in their tills.

The central bank pays keen attention to seasonal variation in currency circulation so as to control the ebb and flow of currency in the country.

BANKER TO THE GOVERNMENT

The central bank acts as banker to the National Government in the sub-continent. It is also banker to the state or to the provincial government as the case may be.

The bank is required to undertake the following functions as banker to the Government:-

1. It is obliged to look after the banking business of the Government free of charge. It undertakes to accept monies on behalf the Central Government to make payment on its behalf and to carry out and other banking operations.

2. It is responsible for management of public debt and the issue of new loans and treasury bills. On account of its close contact with and intimate knowledge of the markets, the central bank is in a position to advise the Government on the quantum, timing and terms of new loan.

   The sale of Treasury bills, which has maturity of three months, provides short term finance to Government. It also helps to absorb any excess liquidity in the market.

3. Ways and means advances are provided to the Government which are repayable not later than three months from the time of making the advance. Purpose of such advances is to bridge gap between expenditure and flow of receipts of revenue. They are meant to provide for marginal and purely temporary difficulties on account of a short fall in revenue as other receipts for meeting the liabilities of the Government.

4. The central bank acts as advisor to the Government not only on banking and financial matters but also on a wide range of economic issues including those in the field of planning and resource mobilization. The Government seeks advise of the central bank on certain aspects of the country's economic planning, such as the financing pattern, mobilization of resources and institutional arrangements with regard to banking and credit matters. The bank also renders advice on matters of international finance.

MONETARY REGULATION

The main function of central bank is to formulate and administer monetary policy. Monetary policy refers to the use of instruments within the control of the central bank to influence the level of aggregate demand for goods and services by regulating the total money supply and credit. Expansion of money supply depends on the creation high powered money (reserve base) and the multiplier acting upon it. The central banks, through the instruments available to it, seek to control both dimensions of money supply change i.e. the issue of high powered money and their multiplier acting upon it.

Process of money creation has been dealt in the document relating to the Federal Reserve System and will not be repeated here. It should, however, be noted that a central bank can regulate the amount of money creation by banks through control of their cash reserves. But in practice the regulation of money supply is not wholly under the Bank's control. It is considerably affected by the budgeting operations of the Government over which the bank has no control. The central bank at best can tender advise. When the Government meet its budgeting deficits by borrowing from the central bank, there will be an increase in money supply both in currency and bank deposits. It may be mentioned that a National Government may borrow from the central bank whenever it chooses to do so. Another source of variation in money supply over which the Bank's influence is restricted is the country's external payment position.

The three important factors having influence on money supply are the following ones:-

1. The net bank credit to the Government.

2. Bank credit to the commercial sector.

3. Net foreign exchange assets held by the central bank.

The combined effects of changes of the above three factors influence the variations in money supply.

IMPORTANCE OF MONETARY POLICY

Monetary policy is regarded as an indispensable tool of economic management. It refers to the use of official instruments under the control of the central bank to regulate the avilability cost and use of money and credit with the object of achiving optimum levels of output and employment, price stability, balance of payments equillbrium or any other goals set by the country.

The efficacy of monetary policy will depend on the following things:-

1. The proportion of currency in money supply.

2. Size of public debt.

3. Non-monetized sector in the economy and presence of active sub-markets.

4. Degree in imbalance in the overall supply demand situation.

5. Trends in agricultural and industrial output and the general price level.

6. The balance of payments situation.

Since the above conditions are always changing the authorities have to adapt to the circumstances in their choice and mix of various techniques, putting emphasis as required on controlling the sources of money supply or interest rates policy.

Monetary policy is also dependent on changes in the banking and credit structure. While the level of savings is basically a function of the level of income, the inadequancies and underdeveloped state of financial market acts as restraint in the effective mobilization of savings for purposes of development.

The objectives of monetary policy have been indicated elsewhere. We need not repeat them. We may, however, note that the central bank attempts ensure an adequate level of liquidity to support the rate of economic growth envisaged and to assist in the fullest possible utilization of resources without generating inflationary pressures.

SCOPE OF MONETARY AND FISCAL POLICIES

Monetary policy is only one aspect of the broader economic policy of the country. The other important component is fiscal policy. They together have repercussions on the whole economy, affecting the price level, level of economic activity, employment and balance of payments. Monetary policy exerts influence on the national economy through the cost and availibility of credit. Fiscal policy, however, is a more important determinant of aggregate demand in as much as it directly affects the financial resources and purchasing power in the hands of the public.

In developing countries fiscal policy is aggressive. Resort to central bank credit for meeting budgetry deficits results in expansion of money supply and therefore in the cost reserves of banks. In such a situation monetary policy has to have restraining influence in expansion of bank credit and at the same time will have to ensure that the genuine credit needs of agriculture, industry, commerce and other product activities are met.

INSTRUMENTS OF CREDIT CONTROL

We will not repeat our discussion here about the quantitative controls. Selective credit controls, however, are widely used in the sub-continent and needs some discussion. It has impacts not so much on the total account of credit as on the direction of credit i.e. on the amount that is put to use in a particular sector of the economy, and they bring to bear a restraining influence on the borrowers. Selective control measures are formulated by the central bank in harmony with the general credit and monetary policies and are operated in cosonance with the policies, priorities and controls of the Government. Selective control is not basically intended to correct general inflationery trends in the economy. It can at best moderate the price rise of a particular commodity. If it is not supported effectively by a restrictive monetary and credit policy, it is not very effective by itself.

The main instruments for selective credit control are:-

1. Minimum margins against selected commodities.

2. Celings on level of credit.

3. Charging of minimum rate of interest on advances against speatied commodities.

The central banks makes considerable application of moral suassion to influence the policies relating to credit supply. All over the world the central banks are heard with respect by the banking community. They may not agree with its views but were not disregard their advise, because no bank can be run effectively without the sympathy and support of the central bank.

THE CENTRAL BANK AND THE RURAL CREDIT

Few aspects of the central bank in Sub-continent, the Reserve Bank of India playing a pioneering role, have been so striking, in comparision with other central banks, or its role in the sphere of rural finance. Their responsibility in this field has been occasioned by the predominantly agricultural bias of the sub-continental economy and the urgent need to expand and coordinate the credit facilities to the agricultural sector. The central banks in the sub-continent maintain Special Agricultural Department with functions as under:-

1. To maintain an expert staff to study all questions of agricultural credit and be available for consultation by the National Government (in case of India and Pakistan by their State and Provincial Governments especially). Cooperative banks and other banking organisation.

2. To coordinate the activities of the central bank in connection with agricultural credit and its relations with the cooperative banks any other banks or organisations engaged in agricultural credit.

At present the specialised banks, nationalised commercial banks and the cooperative banks and some other institutions are engaged in extending short term, medium term and long term finance for agriculture. The short term finance meets working capital requirement of the farmers whereas the medium term and long term finance meet their development needs.

Generous re-finance facilities are extended to the specialised institutions for agricultural financing whereas the commercial banks show a great degree of reliance on their own resources for the purpose.

SUPERVISION OF BANKS

In this area the central banks of the sub-continent enjoy wide powers. Let us look at the weapons the central bank has for this purpose:-

1. Any company wishing to commence banking business is required to obtain a licence from the central bank. Before granting a licence, the central bank satisfies itself by an inspection of the bank's books and accounts and methods of operation that it is or will be in a position to carry out banking business satisfactorily. In case of banks incorporated abroad it will satisfy itself about its strength and will further take note the fact whether the bank is needed in the country.

2. To ensure that banks are organised and operated on sound financial lines, the banking laws of the subcontinent prescribe minimum requirements of paid up capital and reserves, transfer to reserve fund, and maintenance of cash reserve and other liquid assets. Special provisions in laws are made for capital requirements of the foreign banks.

3A. As a part of supervising function, the central bank enjoys powers about issuing licence for opening of branches of any bank. Before giving licence for opening new branches, the central bank ensures that the financial condition and management of the applicant banks are sound and that there are good prospects of business in the areas where bank branches will be opened. Till the sixties the branch licencing system was quite rigid.

B. Since seventies liberal branch licencing system has been followed so that rural and semi-urban areas, backward regions of the countries and underbanked areas get banking facilites. Over the last decade there has literally been an explosion of back branches in the sub-continent. The expansion of branches could be accelerated on account of wide spread nationalisation of banks.

4. However as the metropolitan and urban areas have adequate banking facilities, the banks are discouraged from opening new branches in those places.

INSPECTION OF BANKS

The inspection of the banks by the central bank is its most important supervisory function. Its basic objectives are to safeguard the interest of the depositors and to build up and to maintain a sound banking system in conformity of the banking laws and regulations as well as the country's socio-economic objectives. The inspections serve as a tool for overall appraisal of the financial and managerial systems and performance of banks, toning up of their procedures and methods of operation, and prevention of serious irregulaties.

The central bank conducts ad hoc investigations from time to time into servious complaints, reported major irregularities and frauds. It also conducts sample studies to examine compliance with the selective credit control directives and various instructions issued by it from time to time relating to credit policy.

The course of action to be taken on the basis of the findings of the inspection of banks is decided after their managements have had an opportunity to represent their views on the various features observed and remedial measures proposal. Depending upon the nature of the findings of the inspection, suitable steps are taken or suggested by the central bank to bring about the desired degree of improvement in the working of the bank or changes in its management.

CONTROL OVER METHODS OF OPERATION

Strict control is exercised by the central bank for ensuring that banks do not fritter away funds in improper investments and ill judged advances. The banks are prohibited from undertaking trading activities.

Central bank sees that the commitment towards unsecured advances and guarantees is small.

A bank cannot grant any loan or advance on the security of its own shares or enter any commitment for granting any loan or advance to or on behalf of any of its directors, firms and companies in which the directors are interested, and individuals with whom they are connected as partners or guarantors.

The central bank has powers to approve the apppointment of the chief executive of the locally incorporated private banks. These powers differ from country to country about other executives and directors. In case of the banks incorporated abroad, the central bank satisfies itself that the local chief executive has a sound banking background.

EXCHANGE MANAGEMENT AND CONTROL

The central banks in the sub-continent try to maintain external value of their respective currencies. The external stability of the currency is closely related to its internal stability - the interent economic strength of the country and the way it conducts its economic and monetary affairs. Domestic fiscal and monetary policies have therefore, an important role in maintaining the external value of the currency. But external factors such as international cost price relationships which are beyond the control of domestic policies and restrictive trade practices of major trading partners have a considerable impact on the external value of the currency.

For most non-oil developing countries inadequacy of foreign exchange reserves has been a major constraint on their development efforts. They have, therefore, found it expedient to employ the technique of exchange control to use the limited foreign exchange resources according to a scheme of priorities.

EXCHANGE MANAGEMENT

The central bank has authority to enter into foreign exchange transaction on its own account and on behalf of Government.

Traditionally the sub-continental central banks like other central banks are accustomed to place their reserves with the lending banks e.g. Bank of England or Federal Reserve Bank of New York. The funds are invested through there in Government securities of different maturities. They can be cashed whenever a central bank wants to.

But in recent years the central banks have invested some funds with the reputed commercial banks. Such are investments for one week, one month or three months.

It should, however, be noted that a central bank will not take speculative position with its reserves. This is why they chose to invest in Government securities. But a days one can invest profitably with the internationally reputed commercial banks without taking speculative position.

EXCHANGE CONTROL

While the maintenance of external value of currency can be achieved, as indicated earlier, through the pursuit of monetary and fiscal policies, the objective of exchange control is primarily to regulate the demand for foreign exchange for various purposes within the limits, set by the available supply. Exchange control becomes necessary when the country's external reserves even when supplemented by borrowings from international institutions, foreign governments and other foreign sources are not adequate for meeting its current and potential requirements. It, therefore, involves a rationing of foreign exchange among various competing demands for it. The purpose of having exchange control on receipts is to centralise a country's means of external payments on a common pool in the hands of the monetary authorities to facilitate its judicious use, while the purpose of imposing exchange control on payments is to restraint the demand for foreign exchange broadly in consonance with the national interests, within the limits of available resources.

To a great extent exchange control is related to and supplemented by trade control which is the responsibility of Chief Controller of Imports and Exports. While trade control is concerned with the physical transfers of goods, exchange control involves supervision over the settlement of financial transactions relating to exports and imports. Also while trade control is confined to imports and a few exports, exchange control is more comprehensive in that it covers all exports and imports as well as invisibles and capital transactions. However, trade control, customs and exchange control authorities have close coordination among one another.

For enforcing this provisions of Foreign Exchange Regulation Laws and dealing with prosecutions, and adjudications for evasion of or contravention of the regulations, there is a separate machinery. It is the Directorate of Enforcement of the Government.

AUTHORISED DEALERS

The central banks do not deal in foreign exchange with the public. The day-to-day business of buying and selling foreign exchange is handled by the foreign exchange department of the commercial banks and control is to a large extent operated through them. The central banks in the respective countries have licenced certain scheduled commercial banks to deal in foreign exchange and these are known as authorised dealers in foreign exchange.

Besides the authorised dealers, who are permitted to handle all kinds of foreign exchange business, in order to provide facilities to the foreigners visiting the country, money changer's licence has been given to certain established firms, hotels, shop and other organisations to deal in currency, notes, coins and travellers' cheques to a limited extent.

FINANCIAL STATEMENTS, REPORTS AND PUBLICATIONS

The financial statements, reports and publications of the central bank are of great importance in understanding the economic situation of the country they belong to.

The central banks of the sub-continent publish three financial statements as a part of the legal requirement. These are:-

1. An account of the Issue and the Banking departments or at the close of week;

2. a weekly statement showing the consolidated position of the scheduled books; and

3. the annual balance sheet of the bank in the same form as the weekly statement with the addition of a statement of profit and loss account.

Many central banks like the Federal Reserve Bank and Bank of Japan combine the two and issue one statement. The central banks of the sub-continent follow the traditions of the Bank of England is this respect.

OTHER IMPORTANT PUBLICATIONS

The central banks in the sub-continent issue several periodical publications which contain a comprehensive account of its operations and of trends and developments in the banking and financial spheres, besides detailed statistical information. These publications attempt to explain and assess the significance of the economic developments in the country and also their implications for the working of the central banks, and provide a wealth data for the use of the public and research scholars.

The annual reports of the bank provide keen insight into the economy problems of the country they are related to. A good report can be forthright in its critisim of the policies of the National Government and of others, if they are responsible for weakening of the monetary and price situation in the country. Though a creature of the Central Government, they have to stand up to the Government for free expression of their views, when there is a need of it. Annual report provides opportunities for expression of such views.

ORGANISATION OF THE CENTRAL BANK

The central banks in the sub-continent have many common features. They will have some differences. But relying on their common features we will indicate structure of their organisation.

1. Central Board : The general superintendance and the direction of the banks affairs is vested in the Central Boards of Directors comprising of (a) Governor, (b) Deputy Governor(s) and Directors, official(s) and non-officials nominated by the National Government.

2. The Governor and the Deputy Governor(s) hold office for such periods not exceeding five years as may be fixed by the Central Government at the time of their appointment and are eligible for reappointment.

3. As a matter of practical convenience, the Board has delegated some of its functions by means of statutory regulations to a committee of the central board, consisting of the Governor, the Deputy Governor(s) and a few Directors.

INTERNAL ORGANISATION AND MANAGEMENT

The Governor is the bank's chief executive authority. The Governor is assisted in his performance of his duties by the Deputy Governor(s) and the Executive Director.

Functional specialisation with adequate coordination is the main feature of the bank's internal organisation. The primary functions of the bank regarding note issue and general banking business are exercised through separate departments, namely the Issue and the Banking Departments. These departments constitute what are known as local/branch offices. They are local principal cities of the country.

In the central office there are in the general side, departments to look after bank credit and development, bank inspection, agricultural credit, industrial credit, exchange control, management of central bank's fund, public debt, currency issues and house keeping. All central banks have, however, storng Research and Statistics Department. The Research Department mainly undertakes a wide range of studies on monetary, fiscal, trade and balance of payment problems. The Statistics Department is responsible for publishing wide range of data relating to money, banking, credit, trade and economic activities. The Statistics Department are now computerised to handle the voluminous data the central bank publishes.

FINAL WORDS

The central bank of the sub-continent belong to a common fraterinity. Their banking laws and regulations are so alike as to be practically indistinguisable. All the three central banks have common strength and weaknesses because they have worked in the same economic or social milie, so to say. In all the three countries the fiscal policies are aggressive. The Governments in the sub-continent have strong views on credit policies. The central banks in differenct degree had to subordinate themselves to such policies, particularly since widespread nationalization of the commercial banks. However, like all developing countries the sub-continental ones had to face adjustment problem on account of international economic problems beyond their control. The respective Governments and the central banks had to react to them. Their reaction has more or less been common.

Pakistan in recent years have brought about changes in its banking philosophy through complete Islamization of the system. We are yet to know as to what results it will produce.

The central banks of the sub-continent have competent technical departments. Behind them there is a tradition of half a century. Their exposure is new situations since last world war have given them such experience on central banking. Given the circumstances they face, the central banks have fared well in the sub-continent.

Before we part, we have to say one thing even at the cost of repitation. A modern central bank is a bankers' bank and the bank to the Government. It issues currency over which it has direct control. It also attempts to control the level of deposit creation of other banks through various means because the deposits are money (e.g. the demand deposits) or near money (e.g. time deposits). But the central bank will not have deposits from the public and will not lend to them. They should avoid dealing with the non-banking corporate sector also even when they may belong to the Government sector. It creates complication for monetary management.