Central Banking Practices

Chapter - 3

Central Bank

A central bank, reserve bank, or monetary authority is an institution that manages the currency and monetary policy of a state or formal monetary union, and oversees their commercial banking system. In contrast to a commercial bank, a central bank possesses a monopoly on increasing the monetary base.

“Central Bank is the lender of the last resort”

- Professor Hawtrey

“A Central Bank is a bank to which it has been entrusted the duty of regulating the volume of currency & credit in the country”

- R.P. Kent

Area & Scope/Features/Nature of Central Bank

- Issue of note & currency
- Controlling the value of currency
- Banker of government
- Banker of other banks
- Credit control
- Lender of the last resort
- Clearing house
- Reserving the foreign currency
- Valuation of currency

Objectives of Central Bank

- Welfare
- Issuing currency
- Credit control
- Protecting stability in pricing level
- Developing & managing capital market
- Controlling banking system
- Serving as a bank of government
- Controlling foreign exchange
- Maintaining relation with external world

Functions of Central Bank

General Functions:

- Note issue
- Credit control
- Controlling foreign exchange rate
- Maintaining stability in price
- Maintaining foreign exchange reserve
- Creating opportunity for employment
- Maintaining gold standard

Functions of Central Bank

Functions as Governmental Bank:

- Maintaining government fund
- Maintaining government account
- Economic advisor
- Revenue collection
- Representative of the government

Functions of Central Bank

Functions as a Banker of Other Banks:

- Enrollments of commercial banks
- Lender of the last resort
- Allow the opening of new branches
- Clearing house
- Controlling the functions of commercial banks
- Assists to recovery credit

Functions of Central Bank

Development Functions:

- Developing foreign trade
- Agricultural & industrial development
- Economic development

Other Functions:

- Research
- Creating report
- Collection & supply of data

Credit Control

Credit control, also called credit policy, includes the strategies employed by businesses to accelerate sales of products or services through the extension of credit to potential customers or clients. Central bank administers control over the credit that the commercial banks grant.

Credit control focuses on the following areas: credit period, cash discounts, credit standards, and collection policy.

“Credit control is a set of actions used by a government to reduce the amount of money available for borrowing or spending.”

- Cambridge Business English Dictionary

“Credit control is the system used by a business to make sure that it gives credit only to customers who are able to pay, & that customers pay on time”

- Wikipedia

Objectives of Credit Control

- Stability of internal price-level
- Checking booms & depressions
- Promotion of economic development
- Stability of money market
- Stability in exchange rate

Method of Credit Control

Quantitative Method

- Bank Rate Policy
- Open Market Operation
- Reserve Rate Variation Policy

Qualitative Method

- Rationing Policy
- Direct Action
- Moral Persuasion
- Publicity
- Regulation of Consumer Credit

Principles of Note Issue

- **Currency Principle:**

According to this principle central bank must issue currency against gold reserve or any kinds of reserve. The condition of the reserve is that the central bank can easily convert the reserves into cash at the time of urgent need. This principle is safer but create inelasticity.

- **Banking Principle:**

According to this principle central bank must issue currency on the basis of demand unlikely to the currency principle. This principle tells us that we calculate how much money flow we need and then we supply the cash on the market. This Principle is very elastic and very risky as it will definitely cause inflation due to the over issuance of the currency.

Methods of Note Issue

- The Fixed Fiduciary System
- Maximum Fiduciary System
- Proportional Reserve System
- The Minimum Reserve System

CAMELS Ratings

Clearing House

A clearing house or clearing division is an intermediary between a buyer and a seller in a financial market. In acting as the middleman, the clearinghouse provides the security and efficiency that is integral for financial market stability.

A clearing house is a financial institution formed to facilitate the exchange of payments, securities, or derivatives transactions.

"Clearing house is a central office used by banks to collect & send out money & cheques."

- Cambridge Dictionary

Importance of Clearing House

- Settlement of mutual transaction
- Transfer
- Economic conditions
- Risk minimization
- Liquidity facility
- Credit control

Financial Deepening

Financial deepening is a term used often by economic development experts. It refers to the increased provision of financial services with a wider choice of services geared to all levels of society. It also refers to the macro effects of financial deepening on the larger economy.

Financial deepening generally means an increased ratio of money supply to GDP or some price index. It refers to liquid money. The more liquid money is available in an economy, the more opportunities exist for continued growth.

One of the key features of financial deepening is that it accelerates economic growth through the expansion of access to those who do not have adequate finance themselves.

Economic growth and development of a country depends on the role of financial deepening. It also simply means an increase in the supply of financial assets in the economy. It can also play an important role in reducing risk and vulnerability for disadvantaged groups and increasing the ability of individuals and households to access basic services like health and education, thus having a more direct impact on poverty education.

Loan Classification System

Loan Classification

Loan classification is required to have a real picture of the loan and advances provided by the Bank. It helps to monitor and take appropriate decision regarding each loan account like other Banks, all types of loans fall into following four scales:

- Unclassified : Repayment is regular.
- Substandard: Repayment is stopped or irregular but has reasonable prospect of improvement.
- Doubtful debt: Unlikely to be repaid but special collection efforts may result in partial recover.
- Bad/Loss: Very little chance of recovery.

Loan Classification System

Loan Type	Unclassified (Month)	Substandard (Month)	Doubtful (Month)	Bad (Month)
Continuous Loan(Demand Loan)	Expiry up to 5 month	6 to 8 month	9 to 11 month	12 month+
Term loan up to 5 year	0 to 5 month	6 to 11 month	12 to 17 month	18 month+
Term Loan more than 5 years	0 to 11 month	12 to 17 month	18 to 23 month	24 month+
Micro Credit	0 to 11 month	12 to 13 month	36 to 59 month	60 month+

Paper Standard

Paper standard refers to a monetary standard in which inconvertible paper money circulates as unlimited legal tender. Under paper money standard, although the standard money is made of paper, both currency and coins serve as standard money for purpose of payment. No gold reserves are required either to back domestic paper currency or to facilitate foreign payments.

The paper standard is known as managed standard because the quantity of money in circulation is controlled and managed by the monetary authority with a view to maintain stability in prices and incomes within the country. It is also called **fiat standard** because paper money is inconvertible in gold and still regarded as full legal tender. After the general breakdown of gold standard in 1931, almost all the countries of the world shifted to the paper standard.

Merits of Paper Standard

- Economical
- Proper Use of Gold
- Elastic Money Supply
- Ensures Full Employment and Economic Growth
- Avoids Deflation
- Useful during Emergency
- Internal Price Stability
- Regulation of Exchange Rate

Demerits of Paper Standard

- Exchange Instability
- Internal Price Instability
- Dangers of Inflation
- Dangers of Mismanagement
- Limited Freedom
- Absence of Automatic Working

Monetary Economics

Monetary economics is the branch of economics that studies the different competing theories of money: it provides a framework for analyzing money and considers its functions (such as medium of exchange, store of value and unit of account), and it considers how money, for example fiat currency, can gain acceptance purely because of its convenience as a public good.

This branch also examines the effects of monetary systems, including regulation of money and associated financial institutions and international aspects.

‘Money buys goods and goods buy money but in a monetary economy goods do not buy goods. Really, without money the world would not go around.’

-Professor Bob Clower

Reserve Requirement

Reserve requirements are the amount of cash that banks must have, in their vaults. It is a percentage of the bank's deposits. The nation's central bank sets the percentage rate. A bank holds in reserve to ensure that it is able to meet liabilities in case of sudden withdrawals.

Reserve requirements are a tool used by the central bank to increase or decrease money supply in the economy and influence interest rates.

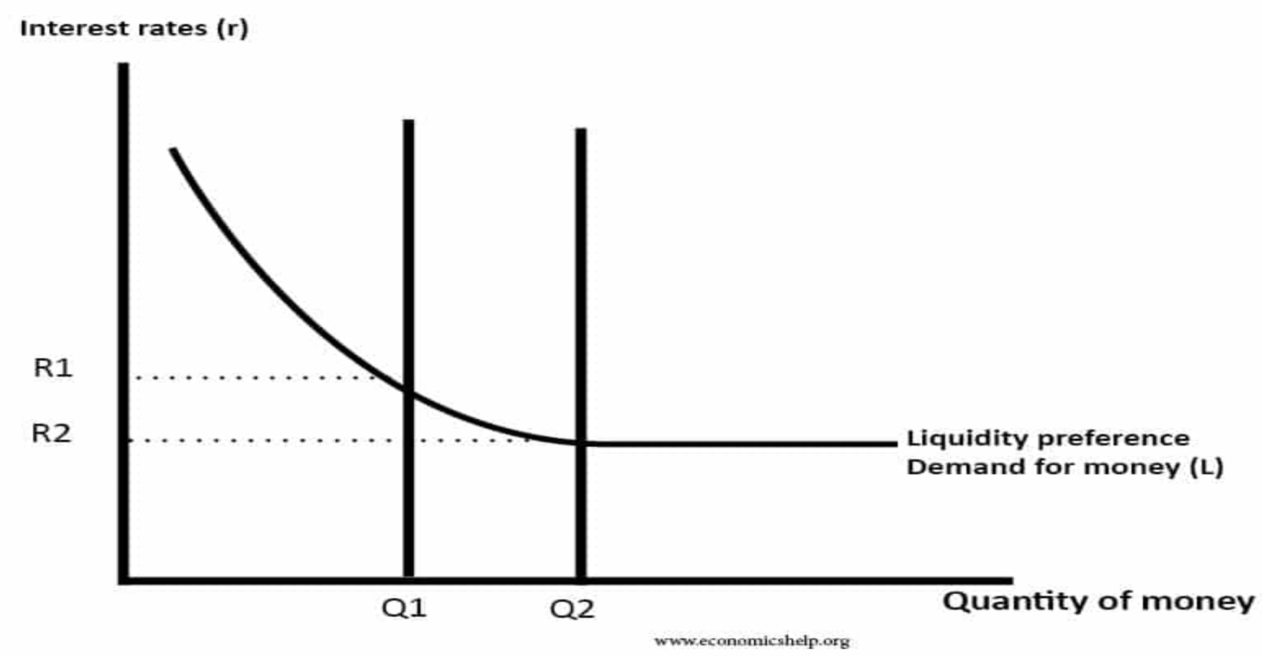
Reserve requirements are one of the three main tools of monetary policy — the other two tools are open market operation and the discount rate.

The reserve requirement applies to commercial banks, savings banks, savings and loan associations, and credit unions.

Demands for Money

In monetary economics, the **demand for money** is the desired holding of financial assets in the form of money: that is, cash or bank deposits rather than investments.

The demand for money refers to how much assets individuals wish to hold in the form of money (as opposed to illiquid physical assets.) It is sometimes referred to as liquidity preference. The demand for money is related to income, interest rates and whether people prefer to hold cash(money) or illiquid assets like money.



Types of demand for money

- **Transaction demand** – money needed to buy goods – this is related to income.
- **Precautionary demand** – money needed for financial emergencies.
- **Asset motive/speculative demand** – when people wish to hold money rather than buy assets/bonds/risky investment.

Fiat Money

Fiat money is a form of currency that is declared legal tender. This includes money in circulation such as paper money or coins. Fiat money is backed by a country's government instead of a physical comodity or financial instrument. This means most coin and paper currencies that are used throughout the world are fiat money.

Fiat money is money that is backed by the government which has little to no intrinsic value in itself.

The various banknotes and coins issued by the government are examples of fiat money. Fiat money on its own is not worth anything. Fiat money only has value because the government sets, regulates, and backs that value.

Commodity Money

We can define Commodity money as a physical good that consumers universally use to trade for other goods. In other words, it is like the money we use today, but has an actual value. For example, gold was used as money, but also in the manufacturing of jewellery. So it had value outside its use as a medium of exchange. In economics, this is known as **‘intrinsic value’.**

Historic examples include alcohol, cocoa beans, copper, gold, silver, salt, sea shells, tea, and tobacco.

There are four main characteristics of commodity money – it’s durable, measurable, easily exchangeable, and rare.

What is the difference between commodity money and fiat money?

The main difference between commodity and fiat money is that commodity money has an **intrinsic value**. In other words, it has a use and value outside of its use as money. For example, gold can be used in jewellery as well as a money. So even if it wasn’t used as money, it has value.

By contrast, fiat money only has value that is guaranteed by government. For instance, if the US government said it was no longer using the dollar, a 1 dollar bill would become worthless.

Representative Money

Representative money is an item such as a token or piece of paper that has no intrinsic value but can be exchanged on demand for a commodity that does have intrinsic value, such as gold, silver, copper, and even tobacco. An item has intrinsic value if it still has value even if it is not used as money.

Representative money is government-produced money backed by a physical commodity such as precious metals. Other forms of representative money are still in place, including financial instruments like checks and credit cards.

Fiat vs. Representative Money

Fiat money is physical money—both paper money and coins—while representative money is a form of currency that represents the intent to pay such as a check. Both fiat and representative money are backed by something. Without any backing, they would be completely worthless.

Fiat money is backed by the government, while representative money can be backed by different assets or financial instruments. For example, a personal check is backed by the money in a bank account.

Function of Money

Medium of Exchange

Unit of Account

Store of Value