BFIs and Commercial Banks

:fore discussing the role and functions of commercial banks and central bank, it is necessary to differentiate :tween NBFIs and commercial banks. NBFIs, like commercial banks, specialize as financial intermediaries :tween lenders and borrowers or the surplus and deficit spending units. They compete closely with banks for .e public's saving and as a source of finance to the borrowers. In India, NBFIs are a heterogeneous group of ıancial institutions such as development banks like the IFCI, IDBI, LIC, hire purchase finance institutions, ıit funds and nidhis. Some people prefer to call some of the NBFIs as 'near-banks' — but not banks in the true :nse of the term.

NBFIs refer to financial institutions whose liabilities (like deposits) are not accepted or used as a means of ıyment in the settlement of debts. But, deposit liabilities of commercial banks are accepted as a means of ıyment. This means that deposits of commercial banks, mainly demand deposits, can be converted into cash ı demand. Such arragements are not made in the deposits of NBFIs, mainly because they generally do not :cept demand deposits. So, we can say that, the main difference between banks and NBFIs arises due to the ifferences in the nature of their liabilities.

Though NBFIs do not accept demand deposits, they do compete with commercial banks in respect of time eposits. Deposits are the principal liabilities of commercial banks.

On the lending side, commercial banks mainly make short-term loans for industrial or commercial purposes. 'n the other hand, NBFIs provide loans for purposes like purchase and repair of houses, aquiring durable ɔnsumer goods (like T.V. sets, refrigerators, etc.). They also provide medium and long-term industrial finance.

Finally, it is believed that like commercial banks, NBFIs cannot create credit. Because of the nature of the abilities (*i.e.*, demand deposits) NBFIs cannot create credit. But, commercial banks can and do act as creators f credit money.

ECONOMIC INSIGHT — GOLDSMITHS FORERUNNER OF MODERN BANKING

A study of a modern economy reveals that our modern fractional reserve banking system has its roots in the goldsmiths who operated hundreds of years ago. These craftsmen, who were in the business of moulding gold into fine ornamental objects for merchants and aristocrats, possessed secured storage facilities for their gold. Rich people, including merchants in possession of gold coins and bullion therefore were attracted to the goldsmiths who used to provide safe means of storing gold at a nominal charge. The latter used to issue a receipt to the owner in exchange for the gold. These receipts were called gold certificates. They were as good as gold because they entitled the bearer to a specific amount of gold on demand. Quite the receipts became widely acceptable as a medium of exchange and began to circulate as money. No one would refuse payment in gold certificates if these were redeemable in gold upon demand.

At the outset, this system involved the creation of no new money. The goldsmiths acted as mere warehouses for gold, issuing receipts for gold deposits and maintaining the metal as 100 per cent backing behind the receipts. Soon, however, the goldsmiths noted that withdrawals of gold on a particular day were just a small proportion (a tiny fraction) of total gold deposits. Furthermore, on a typical day the new gold deposits that arrived were almost equal to the amount demanded for withdrawal.

Those goldsmiths who could take note of this reality saw an opportunity for earning handsome profits without undue risk. So they started making loans to local merchants or other reputable borrowers and earn interest income by doing so. Soon the goldsmiths stated granting loans by issuing new gold certificates or by loaning out some of the gold deposited by other individuals.

Although this procedure was probably illegal, the goldsmiths were engaging in money creation. Whenever they granted new loans the value of the medium of exchange increased, *i.e.*, the currency component of the money supply increased. Of course, the goldsmiths no longer maintained 100 per cent gold backing behind the paper currency in circulation. Later in this chapter, we will note the analogy to our modern banking system, the main difference being that the process is now perfectly legal.

THE COMMERCIAL BANKS

Evolution of the Banking System

ın the provision of credit money, a special part is played by the banking system of a country. The banking ;ystem of a country covers mainly the central bank and the commercial banks. Indigenous banks are also ncluded in the banking system of a country.

In the barter age, when goods bought goods, there was no room for credit money. Thus, people at that time lid not feel any necessity for setting banking institutions to deal with credit. Once money was invented (may be in the nature of commodity money) the need for establishing credit institutions appeared to be urgent and pressing. As it is very difficult to say precisely when money was invented, it is equally difficult to ascertain the exact timing of the evolution of the banking system.

However, the word 'bank' is derived probably from the Latin word 'Banco' which means specially designed long chair. In ancient times, the Jew money-lenders conducted their money-lending business in Italy at specially designed 'Banco'. When a moneylender failed, his bench was broken or thrown away and in this way came the word 'bankrupt'. Some of these Italian merchants migrated to England to start this type of business or 'benching' or banking as it was called by the English. These merchants were indeed ancestors of the modern banker.

However, the present-day banker has three ancestors: the merchants, the money-lenders and the goldsmiths. The merchants, to carry out trade and commerce, issued documents instead of carrying metal money from one place to another, which were used everywhere as titles of money. Because of high and widespread reputation of merchants, people were not hesitant in the settlement of debts or obligations. In this way, documents of merchants acted as 'money-substitutes' or a type of 'credit instrument'. However, the credit instrument of the merchants can be rightly called as *hundi* or commercial paper in the credit parlance. The next ancestor of a modern banker is the so-called moneylender. Besides lending money primarily, he also accepted deposits from the public. According to superficial but useful history, banking began with the ancient goldsmiths. The goldsmith ancestory of commercial bank is a purely British affair. People used to keep their gold and valuables for safekeeping with the goldsmiths and get deposit-receipts as evidence of their acceptance of deposits. Initially, the deposit receipts were used for withdrawing people's gold. But, with the passage of time, as people's confidence on goldsmiths developed more and more, deposit receipts came to circulate in the economy as money. It was also found that only a portion of deposits would be generally withdrawn, and the goldsmiths could issue deposit-receipts in excess of their stock of gold. Only a fraction of their liabilities (i.e., people's deposit) had to be met by actual cash payments. In this way, deposit receipts came to act as money. Then notes were printed and lent out to finance business. This is how commercial banks have developed in its modern form.

Definition of a Bank

The above story suggests that any institution which deals with credit may be called a bank. Anyway, the word 'bank' is used in a wider as well as narrow sense. In the broad sense of the term, any institution that accepts deposits from the public who have more cash than it needs immediately, and that gives loan and thereby can create money may be called a bank. Commercial banks perform all these functions, while savings banks and investment banks provide more limited service. Prof. G. Crowther says that, "a banker's business is to take the debts of other people to offer his own in exchange, and thereby create money." According to Prof. Cairncross, "A bank is a financial intermediary, a dealer in loans and debts". These definitions of a bank are purely functional definitions.

However, the legal definition of a bank is somewhat narrower. The banking laws of every country specify which institutions can be called banks or non-banks. An individual transacting banking business may not be called a banker, if he does not get legal approval from the central bank of a country concerned. In India, only joint-stock companies holding licences from the RBI can call themselves as banks. According to the Banking Companies Act (now the Banking Regulation Act) of 1949, "Banking means the accepting, for the purpose of lending or investment, of deposits of money from the public repayable on demand or otherwise."

Functions of Commercial Banks

In a modern economy, various types of banks are found to operate — each specializing in a particular type of business. Banks carry out many functions but, above all, banking is a business like any other business. This means that the aim of banks is to make profits.

Here we will summarize the various functions of a commercial bank of a country. They are as follows:

(a) Mobilization of savings: Commercial banks accept deposits from the public who have surplus funds. Individuals and companies can deposit money with a bank by opening an account. Banks mobilise people's savings by offering interest on the deposits. In this way, banks help deposits to come to banks and help in mobilising saving and develop a habit of thrift among people.

Bank deposits are usually of three types — demand deposits, time or fixed deposits and savings deposits. Demand deposits or current deposits are withdrawable at any time on demand. No interest is paid on these deposits. However, banks, in return, provide some services (*e.g.*, cheque facilities) at a very modest fee or without fee.

Term or time or fixed deposits are withdrawable only after the expiry of the stipulated time, but not on demand. However, premature withdrawal of fixed deposits is permissible, provided the depositor is willing to lose some interest income on those deposits. Cheque facilities are not provided to these depositors.

Savings deposits combine features of both current deposits and term deposits. These deposits are withdrawable on demand by cheque but with certain restrictions. Though no interest is paid on current account, saving deposits do earn some interest.

(b) Granting loans: Commercial banks are not only borrowers of money from the public but also are providers of credit. Banks lend money in several ways but they all cost the customers who borrow. They must pay back the loan with interest and it is in this manner that banks make a profit.

The name commercial bank is derived from the fact that such banks, in the past, used to provide the bulk of their credit for purposes of commerce only. Nowadays, they grant credit to all the sectors of the economy. Usually, they finance all types of economic activities for a short-period against readily realizable assets. At present, commercial banks are also giving medium and long-term credit, particularly in agriculture and industry. Such loans are given in various forms such as cash credit, discounting of bills, overdraft facilities and investment of company shares and long-term Government securities. Of late, commercial banks are financing construction of houses. They are also offering consumer credit.

(c) Agents of payment: For customers with current accounts banks will pay those people or companies to whom the customer owes money. This is done by transferring money from one account to another on the instruction of the customer using a cheque, standing order, direct debit instruction, etc.

(d) Credit creation: The most important function of commercial banks is the creation of credit. By credit creation, we mean the potentiality of banks to expand or contract demand deposits *via* more or less loans and advances. This explains the saying 'every loan creates a deposit'. An increase in bank credit is equivalent to multiplication of bank deposits. This important characteristic of banking institutions will be discussed in detail below.

(e) Developmental functions: Economic development of a country is largely conditioned by the availability of banking facilities in a country concerned. In other words, modern commercial banks perform certain functions that help the process of economic development. The aforesaid functions are merely traditional functions. In addition to these, their constructive functions are of vital significance. India's commercial banks help the Government in various ways to implement Five Year Plans. For instance, they give loans to certain top priority sectors, open branches in unbanked and underbanked areas to help them develop economically. These are the developmental functions of commercial banks. Thus, banks are the instrument of social and economic progress.

(f) Miscellaneous functions: Commercial banks also perform a variety of other functions. These are the following:

(*i*) provision of safety vaults or lockers to keep valuables;

(*ii*) rendering agency services like payment of insurance premium, electric bills, etc.; sale of national savings certificates, units of UTI, etc.;

(*iii*) provision of transfer of funds from one place to another within and outside the country;

(*iv*) dealings in foreign exchange;

(*v*) issue of travellers' cheque, gift cheques, etc.

Looking at the functions of banks like this it can be seen that the services offered by banks attract customers so that they will deposit money which can be lent out at a high rate of interest.

In view of these multifarious functions, Prof. Walter Leaf comments that, "The banker is a universal arbiter of the world's economy". Its role in any economy cannot be denied. See Fig. 37.3.

Changes in the volume of deposits withdrawable by cheques (here, the money supply) in the nation are intimately connected with the activities of banks. Therefore, it is essential that we learn about the nature of banks and their role in the money-creating process.

PRINCIPLES OF COMMERCIAL BANKING: DISTRIBUTION OF COMMERCIAL BANK ASSETS

As part of the money market, commercial banks deal in short-term funds. They lend money to industry, trade and commerce and sometimes to various governments or even consumers. And their working capital consists of deposits collected from households and others. These deposits are withdrawable either on demand (demand

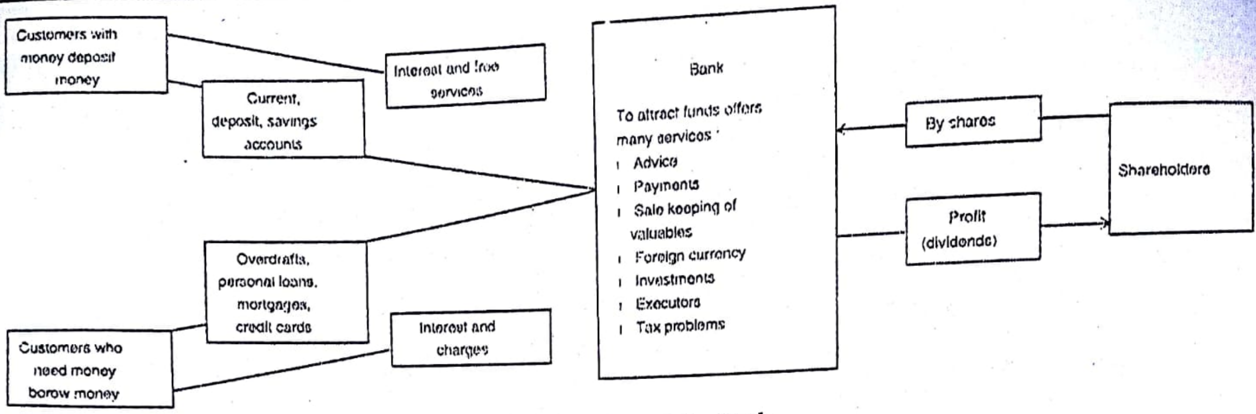

Fig. 37.3 : The Role of the Banks

deposits) or at short notice (time deposits). If a bank lends money for an indefinite period, its liquid assets will be blocked and it will be unable to meet the demand for cash in times of need. Oppositely, if it keeps a high proportion of money as reserve, its profitability will be eroded. Thus, it will have to strike a balance between liquidity and profitability. Similarly, if it is unable to call back loan in time, it may go into liquidation and may be unable to meet the demand of the depositors to withdraw money.

Commercial banks are profit-making institutions. To maximize its profits, prudent bank managers continuously change their investment portfolio. On the other hand, depositors of commercial must be assumed of setting back their deposits in time. Thus the opportunities for expansion of banking business and hence the volume of profit depends on the soundness of a bank. In order to maximize its profit, a bank lends money to the public on the basis of its asset portfolio. Hence the necessity of the managing of the portfolio of assets. Truly speaking, the soundness of a bank gets reflected in the distribution of bank funds in different types of assets. Assets of commercial banks comprise cash-in-hand and with the central bank and other banks, money at call and short notice, investment in government and other securities, loans and advances. In addition to these current assets, banks have also fixed assets.

A glance at the balance sheet of a bank shows that cash-in-hand and with other banks are kept as reserves by banks to meet the demands of depositors. Usually, this liquid asset constitutes roughly 8 per cent to 10 per cent of the total assets of a bank. It is to be noted that holding cash reserves in greater amount will definitely reduce the profit-earning capacity of a bank since cash yields no return.

The next item, in order of liquidity, is money at call and short notice. This comprises short-term loans repayable on demand or at no more than 14 days' notice as in the U.K. This sort of asset constitutes roughly 2 per cent of total bank assets.

Another important liquid asset is the short-term bills whose maturity period is generally 90 days. These assets, therefore, consist mainly of bill of exchange.

The next item, again in order of liquidity, is the investment in government and other securities. These investments are attractive to banks since they fetch high return. However, high-income yielding asset always involve risk. It may be noted that in India the commercial banks are required by law to invest a given percentage of their deposits in government securities. But legal requirements apart, the investment in government securities by banks ensures that the liquidity position such as these can be readily converted into cash.

Loans and advances by the banks to industries and traders are the most profitable form of asset. It is against these profitable assets that liquid assets have to be balanced.

It is worthwhile noting that the asset structure of different banks will vary depending upon the composition of their deposits. A bank that has relatively more demand deposits will have to keep a greater proportion of its assets in liquid form. On the other hand, if a bank possesses more time deposits, it will need to hold a relatively smaller proportion of its assets in cash.

It is to be mentioned that maintenance of liquid assets is a basic priciple of sound banking. But, maintenance of sufficient liquid assets will reduce the profitability of banks, although the main objective of commercial banks is profit, maximization. In view of this, commercial banks, while distributing its assets in different forms must, follow *three* major principles, *viz.*, safety, liquidity and profitability. These may how be discussed.

Safety: The prime consideration of a bank is safety and security. Banks are profit-earning institutions. A commercial bank would have been in a happier state if it can give loans and advances against all the deposits it receives from the public. But deposits are the liabilities of the bank. It must meet the depositors' claim on demand. If it fails do this it may go bankrupt. In view of this, a prudent bank manager should maintain adequate cash to honour depositors' demand. That is to say, commercial banks must maintain a 'safety-limit' of its assets such that it can honour every cheque presented to its window.

Liquidity: Liquidity means capacity to produce cash on demand for deposits. "The acceptability as money of deposits in a particular bank depends on complete confidence in the abilities of that bank to exchange its promises (deposits) for other forms of money (directly or indirectly cash) on demand. A bank must, therefore, so conduct its business as to maintain liquidity." We have already said that by liquidity we mean convertibility of assets into cash commercial banks must maintain liquid assets to meet the demands of both depositors and borrowers. Cash is a perfect liquid asset. But cash yields no return. On the contrary, banks are profit seeking institutions. The lure of immediate profit encourage the banker to economise *i.e.*, minimize cash holding, but liquidity considerations encourage him to maximise his cash holding which may generate a larger flow of deposits (funds) by increasing people's confidence and enable it to maximise profits in the long-run.

Profitability: If the banking business is guided by the principles of safety and liquidity, profitability of banks will definitely be eroded. Profitability and liquidity are to be attached due consideration simultaneously in deciding about the composition of bank assets. If a bank decides to maintain perfect liquidity, its profit will be nil. On the other hand, if a bank lends all their money without bothering about liquidity, it won't be able to meet the demand of the depositors. Hence, the need for making a pragmatic compromise between profitability and liquidity.

In view of this, it is said that, "A constant tug of war between the competing aims of liquidity and profitability summarizes the functions of a modern bank." These two concepts are not in themselves conflicting, but pursuit of them does involve a bank in a conflict of interests. Thus there a trade-off between liquidity and profitability for the banker. Bank satisfies these apparently incompatible requirements in the way it distributes its assets. These assets can be arranged in the following table with the most liquid but least profitable ones at the top and the least liquid but most profitable towards the bottom:

TABLE 37.2 : Financial Assets of Commercial Banks

Liquidity	Assets	Profitability
		Least
Greatest		P
L	1. Cash in hand	R
I	2. Cash at the Central Bank	O
Q	3. Money at call or short notice	F
U I	4. Bills discounted	I T
D	5. Government securities	ABILITY
ITY	6. Loans and advances	Greatest
Least		

THE ESSENTIALS OF A SOUND BANKING SYSTEM

There are certain essentials of a sound banking system. We have already discussed the first two essentials, *viz.*, solvency and liquidity. Others are the following:

(1) *Safety*. Since bank deposits constitute the bulk of purchasing power it is imperative that bank deposits are safe. In other words, banks should be in a position to repay deposits as and when demanded. If people lose confidence in banks, they will hoard money, thus affecting production and capital formation so much needed for economic growth.

(2) *Monetization*. The banking system should be spread all over the country to reach most people. Otherwise, there will remain a large non-monetized sector. This will hamper production, growth of small savings and banking habits.

(3) *Stability*. There should not occur a disproportionate expansion and contraction of bank credit. This may cause either inflation or deflation. To ensure price stability the lending policies of banks should be stable. And it is the duty of the central bank to guarantee its success through appropriate measures.

(4) *Elasticity*. Finally, since banks can create credit within certain limits this empowers banks to impart elasticity to the supply of loanable funds. Most businesses depend on bank credit for meeting working capital needs. So supply of credit should be elastic, *i.e.*, increase or decrease with the volume of business.

CREDIT CREATION

Creation of credit is one of the most important functions of a modern bank. A bank has sometimes been called a factory for the manufacture of credit. Here, we will examine the money-creating role of commercial banks.

Money Creation by a Monopoly Bank

First, we will discuss the money creating potential of a single bank, that is, a monopoly bank. This model is based on the following assumptions :

1. The public holds all the cash it desires. Thus, any additional money created will all be deposited in banks, from which loans can be made.
2. The bank lends all deposits up to the legal minimum cash reserve ratio set by the central bank. It is also assumed that the monopoly bank maintains no excess reserves above the legal minimum. Let the minimum cash reserve be 20 per cent.
3. There is no leakage of cash. This means that every loan creates a deposit. Loans once sanctioned by the single bank are deposited entirely in the same bank.
4. The assets of the bank are just cash reserves and loans. Its liabilities are only deposits.

Now we represent the assets and liabilities of the monopoly bank in a simplified balance sheet. Suppose the bank, in which an individual has deposited Rs. 1,000, keeps 20 per cent as cash reserve to meet the demand for withdrawal by depositors.

In a modern economy bank reserves are held either as cash in hand or as deposits with the central bank. In India, commercial banks keep two types of reserves — primary and secondary. The former is called statutory liquidity ratio (SLR) and the latter cash reserve ratio (CRR). It is enough if a bank keeps just 1 or 2 per cent of its assets as reserves. In most cases this is sufficient to meet the day-to-day demand for withdrawal. Stil banks are required by law to keep a much larger percentage of their deposits as reserves. The main function of legal reserve requirements is to enable the central bank to control the amount of chequing deposits that banks can create. By imposing high fixed reserve requirements, the central bank can better control the money supply.

TABLE 37.3 : Monopoly Bank : Initial Balance Sheet

Assets		Liabilities	
Minimum Cash reserves (*R*)	200	Deposits (*D*)	1,000
Loans (*L*)	800		—
	1,000		1,000

TABLE 37.4 : Monopoly Bank After a Deposit of Rs 100

Assets		Liabilities	
R	300	*D*	1,100
L	800		
	1,100		1,100

We are assuming that the central bank, via an open market operation, purchases for Rs 100 a government bond held by an individual. By assumption 1, the individual puts the money obtained by the sale of bond at the commercial bank. The balance sheet after this is shown in Table 37.3.

Consequently, the bank now has an actual reserve ratio (R_r) *of 0.273* ($= \frac{\text{Rs } 300}{\text{Rs } 1100}$) *which exceeds required reserve ratio* (RR_r) of 0.20. Obviously the bank enjoys excess reserve to the tune of 0.073 (= 0.273 - 0.20). Now, the monopoly bank is in a position to give loan out of its excess reserves. Consequently, because of the assumption 3, the entire amount of loan will be placed on deposit in the bank. The bank is thus now faced with the task of determining the maximum amount by which it can increase its loans without having its reserve ratio drop below the CRR. However, the fact remains that the total increase in money supply resulting from an open market purchase of Rs 100 would be Rs 500.

This point can be explained on the basis of the following formula, whice will tell us how much the monopoly bank should increase its loans. Assuming equilibrium and hence no excess reservcs

38

Central Banking and Monetary Policy

There have been the great inventions since the beginning of time : fire, wheat and central banking.

Will Rogers

FUNDAMENTAL QUESTIONS

1. What is the role of central banking in a modern economy ?
2. Why is the central bank called the lender of the last resort?
3. When does the money market reach equilibrium ?
4. What is monetary (credit) policy ? How does it affect the equilibrium level of national income ?
5. What are the functions of central bank ?
6. How is monetary policy set ?
7. What are the tools of monetary policy or instruments of monetary control ?
8. What is the role of the central bank in the foreign exchange market ?
9. How effective is monetary policy in inflation in developing countries ?
10. What is the role of the central bank in promoting economic development ?

PREVIEW

In the last chapter, we learned about money and how banks create money. We have noted that the quantity of money is a measure of what individuals and business firms have available for spending. In this chapter we will observe that money affects prices, investment, the level of income and foreign exchange rates. Since money is so important, every government controls the size of its money supply through the central bank. In our country the Reserve Bank of India (RBI) is responsible for the conduct of the Government's monetary (credit) policy.

The interest rate and level of income are critical factors in determining how an economy performs. This very fact explains why every government has some means of effecting monetary policy. In India, the RBI sets and implements monetary policy by raising or lowering bank reserves and intervening in the foreign exchange market to control the money supply.

In short, the central policy-making arm of the India's monetary authority is the Governor of the RBI. Economists at the RBI attempt to apply monetary policy in a manner that keeps inflation under control while maintaining economic growth.

The central problem facing the RBI is to determine the proper quantity of money to supply to the economy. If the RBI supplies too much money, inflation will result. If, on the other hand, the RBI fails to supply sufficient funds, interest rates will rise and this may cause recession. In order for the economists at the RBI know whether there are underlying inflationary pressures in the economy there is need to forecast.

Commercial banks literally create money. This function is accomplished through extending loans and making investments. To do so, banks need reserves which are provided primarily by the central bank, the bankers' bank. The essence of monetary policy is to control the release of reserves in a manner which stimulates bank lending and investing in support of consumer and business spending as well as government expenditure in order to foster economic growth without contributing to demand-pull inflation. As a consequence, monetary policy has the capacity to exert an enormous impact on the level of employment, the volume of output and the rate of inflation and serves as a major policy tool for influencing economic activity.

The earliest observations suggest that the central bank has no control over the growth of money and credit. This is essentially true over the short-run. In time, however, although belatedly, there is a positive reaction to monetary policy. An expansion of credit and deposits subject to reserve requirements, which is disturbing to the central bank, will create a need for reserves in excess of the central bank's willingness to meet. At this point, the lines at the central bank's discount windows begin to increase. As such borrowings rise, and especially as they are prolonged, monetary policy becomes increasingly effective. In fact, there is much to be said in support of the role of monetary policy in fostering a nation's well-being. In no way can a steep or even a moderate rate of inflation be stopped if monetary policy allows banks credit and money supply growth to fully accommodate price excesses. By the same token, monetary policy alone cannot effectively dampen inflationary excesses. For this reason the fight against inflation requires restrain of central government expenditures to help curtail excessive demand pressures on the economy.

INTRODUCTION

At present there is no country in the world of any importance that does not have a central bank. The establishment of a central bank in a modern economy is essential as it is the apex institution of a contry's financial as well as monetary system. In fact, every independent country must have a central bank for organising, running, supervising, regulating and developing its monetary (financial) system. Implementation of the government's economic policy requires the presence of central bank which stands as the undisputed leader of the money market. In view of this, some people feel the central bank is one of the inventions of modern civiliZation.

The first central bank was estiblished in the eighteenth century. Though the Riks Bank of Sweden was set-up in 1656 and the Bank of England in 1694, the latter started functioning as the central bank of England in 1884. It is said that the Bank of England is the oldest central bank of the world. In America twelve Federal Reserve Banks started functioning as the central bank in 1913. The post-Second World War period witnessed a phenomenal growth of central banks in various countries. At present nearly 150 central banks is operating throughout the world the world. It will not be out of place to mention here that in each and every country there must exist a central bank. But this is not true in the case of the USA where there are 12 central banks, called Federal Reserve Banks. The co-ordinating central body of these banks is the Federal Reserve Board. Of course, the Federal Reserve Board is not the central bank of the U S A. In fact, the Federal Reserve Banks are quasi-government banks. They are an admixture of private ownership and public control. But at the same time these 12 banks are not guided by the profit motive like most private enterprises. The Reserve Bank in India — the central bank of our country was set-up in 1935. A look at the note issuing function of banking system enables us trace out the evolution of central banking. In the nineteenth century commercial banks were given the power to issue currently notes. But notes issued by them created many a problem such as lack of uniformity, over-issue or under-issue of notes and so on. To avoid much problems note issueing power was gradually shifted to the central bank. In 1814 the central bank of Holland and in 1884 the Bank of England were given the monopoly power of note issue. In view of this the central bank came to be defined as the note-issuing authority.

Meaning and Definition

We all have a rough idea of what is meant by the central bank but it is somewhat difficult to suggest a precise and an appropriate definition of a central bank. However, the best way to define a central bank is to refer to its functions. It can be defined as the bank which stands as the lender of the money market (*i.e.*, the bankers' bank), issues notes and coins, supervises, controls and regulates the activities of the banking system and acts as the banker to the government. In the pyramidal financial structure of a modern economy the central bank lies at the top. In other words, the central bank is the head of the banking institutions of the country. The central bank as the apex institution of the monetary and banking structure of a country seeks to manage a macroeconomy in such a fashion as to promote social welfare. "The guiding principle of a central bank," says De Kock," is that it should act only in the public interest and for the welfare of the country and without regard to profit as primary consideration." According W.A. Shaw, the central bank is that bank which controls credit. Paul Samuelson defines central bank as a bank of bankers. Its duty is to control the monetary base or high powered money and, through this, the community's supply of money.

Major Functions

One can find some difference in the style of functioning of a central bank in difficult countries. Its functions in less-developed country differ from those in a developed country. But, the central bank performs certain common but vital functions in every country. The most important ones are the following :

(a) Monopoly power of note-issue. In the nineteenth century, commercial banks in many countries enjoyed the power to issue notes. As the notes issued by them lacked uniformity, governments in many countries began to perform this function. But, governments could not be prevented from over-issuing (or under-issuing) notes. In view of these problems, the central bank has been given the monopoly power of note issue. It has been empowered to do so in the interest of uniformity and to bring a balance between the demand for money and the supply of money (*i.e.*, prevention of over-issue or under-issue of notes). Being the sole supplier of money in the economy, the central bank regulates the volume of currency in circulation.

(b) Bankers' bank. Commercial banks are required, by law or convention, to keep a certain percentage of their deposits as reserve with the central bank. In this way, it acts as custodian of cash reserves. Banks draw cash balances from the central bank as and when the situation demands. As a banker's bank, it acts as a lender of the cost resort. If commercial banks face serious liquidity crisis they approach the central bank and it extends ts lending hand to them either by discounting bills or buying securities from them. This sort of accommodation nakes the central bank a lender of the last resort, i.e., the ultimate source of funds in the money market.

(c) Banker, agent and adviser to the government. The central bank acts as a banker, agent and adviser to the government. As a banker of the government, it has to maintain banking accounts of both central and state governments. It makes and receives payments on behalf of the government as it acts as the agent of the government. It also provides short-term loans and advances (known **as ways and means advances**) to the government to enable the latter to tide over its financial difficulties. It also advises the goverment on necessary monetary and financial matters such as market borrowing, loan repayment, deficit financing, control of inflation and so on.

(d) Controller of credit. In a modern credit-oriented economy, bank credit is an important component of money supply. Being profit-seeking institutions, commercial banks may adopt of policy undue expansion or contraction of credit to suit their needs. This may lead to inflation or deflation, neither of which is desirable. To ensure price stability the supply of bank credit is to be regulated. And this task has been entrusted with the central bank. The central bank, through its credit control policy, seeks to curb the lending potential of commercial banks. The basic objective is to keep the supply of bank credit within limits. And this is supposed to be the most important function of the central bank.

(e) Custodian of foreign exchange reserves : The central bank acts as the sole custosian of gold and foreign currencies for the purpose of issuing notes and for correcting a deficit in the balance of payments. In this connection, one may note that by holding gold and foreign currencies the central bank intends to stabilize the external value of the country's currency. Like internal price stability, this is equally important.

(f) Promotional and developmental functions : The aforesaid functions are traditional function in the sense that being a central bank, it has to perform those functions as per convention. In this respect, the central bank of a developed country does not differ from its less-developed counterpart. But, in a less-developed economy, the central bank acts not only as a controller and regulator of credit but also as a promoter. Its task in such a framework is (*i*) to develop the money and capital markets; (*ii*) to strengthen the banking system; (*iii*) to meet the genuine financial needs of agriculture and industry; and (*iv*) to curb the harmful activities of moneylenders. In sum, it corrects the inefficiences and defects of the country's monetary-cum-financial system. These activities can be treated as non-traditional or promotional functions. Thus the pattern of economic development in low income countries is largely determined by the central banks. Central banks of developed countries need not perform these functions since their monetary-cum-financial arrangements are of high standard.

Conclusion. However, it is futile to single out the most important function of a central bank. In fact, all the functions are important from the point of a developing country. The functions performed central bank are of great importance. The soundness of the monetary and the banking system of the country depends on the efficiency of the central bank. Central bank seeks to promote the interest of the society. However, as far as promotion of growth with stability is concerned, there is no hard and fast rule. This explains why the role and functioning of a central bank keep on changing with the passage of time.

Distinction between Central Bank and Commercial Bank

The role and functions of a central bank are quite different those of commercial banks. The main points of difference are the following :

The *first difference* between the two types of bank lies essentially in their objectives. Commercial banks do business to earn profit, but the central banks aims at controlling the operations of the economic system. In other words, while commercial banks are guided by the profit motive the central bank seeks to provide public service and thus to promote the interest of the community.

Secondly, the central bank an apex institution of the banking system, controls and supervises the activities of commercial banks.

Thirdly, the central bank acts as the banker to the government. Commercial banks are not entrusted with this job.

Fourthly, being a bankers' bank, the central bank does not deal with the public directly. But the main function of commercial banks is to prouide credit to trade and industry. Actually, the central bank does not perform ordinary banking functions.

Fifthly, the central bank is bank of issue. Commercial banks do not enjoy the right issuing notes and coins.

Sixthly, the central bank, being a custodian of foreign exchange reserves and gold, maintains exchange rate stability. On the other hand, commercial banks carry on the business of buying and selling foreign exchange.

Central Banking in Less-Developed Countries

The central bank plays a pivotal role in less developed countries (LDCs) like India. In advance countries the central bank acts as effective regulator of the currency and credit supply of the country with a view to moderating the swings in business activities which act as a growth-retarding factor. In the post-Keynesian era it has become increasingly clear that money supply or more generally, currency and credit supply—is not a passive factor in economic development but is a significant determinant of such development. All over the globe the monetary authorities and people at large, have by now come to realize the importance of a growth-oriented monetary policy under the effective and dynamic leadership of the central bank.

In most LDCs the problem is not of maintaining but rather raising the growth rate above its current level. In such a framework the central bank's monetary policy assumes added significance. A quote from an Indian authority : "A dynamic monetary policy under the effective hegemony of the central bank of a country can boost up the saving-income ratio in a number of ways as also canalize the supply of increased saving that is generated in the process of economic development in the socially desirable lines, which for such economies coincide more or less with those lines investment which maximize the growth potential". For example, the central bank can generate forced savings from people by increasing money supply, raising the price level and thus taking away a part of people's income for more investment and further growth.

Moreover, the central bank plays a promotional role in developing countries. In most LDCs the money and capital markets are not in good shape. The banking system finances only the traditional lines of activity and fails to perform necessary function so as to move in dynamic spheres. The banks mainly finance seasonal movement of crops and traditional export-import business. In such a situation, the central bank as the head of the banking system of a country will have to take the lead in the process of planned industrialization by bridging the gap left by the private sector. It will have to set-up commercial banks, term-lending institutions, co-operating saving societies and development finance corporations. In short, the imperfections in the money and capital markets should be reduced by creating or expanding flexible monetary and credit institutions. Moreover, with economic development there occurs an increasng degree of monetization of the hitherto non-monetized sectors of the economy. Consequently, the volume of transactions goes up. The central bank through its power to expand currency and credit in suitable directions and to canalize the credit flow in proper lines can ensure that the economy is kept on a stable path so that there is neither deflation nor inflation which would jeopardise the whole process of growth. Moreover, an increase in transactions demand for money will reduce total money supply because people would keep more money in their own pockets to buy more goods and services. This will raise the rate of interest and affect the investment decisions adversely. A chain reaction would occur. The central bank can control this tendency through by making appropriate and thus provide a favourable climate for economic growth.

CREDIT CONTROL : OBJECTIVES AND TECHNIQUES

Credit control implies control over the volume of bank (or commercial) credit. The volume of credit depends on the volumes of loans given by the banks at a point of time. Hence credit control necessitates control over the lending activitics of commercial banks by the central bank. Credit policy is an important adjunct of monetary policy. The volume of credit at a particular point of time constitutes a major part of total money supply. Too much credit may cause inflation by raising price and giving artificial encouragement to producers. It may also raise imports because of higher domestic prices in periods of inflation, reduce exports (because it is profitable to sell goods at high prices) and thus cause balance of payments deficit. Contrarily, too little credit may cause deflation. It may affect production, employment and income. The central bank, as the central monetary authority of the country, should always seek to counter both these destabilizing forces by adopting a rational credit policy. The basic point is that credit control is felt necessary only for adjusting the volume of credit to the volume of business. When business expands more credit is required. And when business contracts the need for credit is reduced. So there is a need to strike a proper balance between the volume of business and the volume of credit since a lack of balance would set in motion destabilizing forces. Therefore the central bank should, of necessity, regulate the volume of credit in consonance with the needs of trade and industry.

1. *Price stability*

Perhaps the most important objective of the central bank's monetary policy is to ensure price level stability. And since credit forms a major part of the total money supply in the country, an effective control over the