THEORY AND PRACTICE'S OF CENTRAL BANKING

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INTRODUCTION

- Both the theory and practice of Central Banking have evolved over time, responding to exigencies of emerging economic situations.
- A quick glance at the history of Central Banks, over the World, would show that their functions differ from country to country and from developed countries to developing countries.

GLOBAL EVOLUTION OF CENTRAL BANKS

1. WAR FINANCING

- Economic historians have pointed out that war finance was the prime consideration for constitution of many of the early Central Banks.
- Also, war financing led to nationalization of many Central Banks, which till then were functioning as private entities.
- Once the specter of war receded, the role of central banking came to be increasingly focused in mobilizing resources for planned development and at the same time in tackling high inflation.
- The study of evolutionary process of central banking over the world and in India is very interesting and informative.
- At that point of time, central banks performed minimal functions like being the lender of last resort.
- In most countries central banks were also given the monopoly of note issue.

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2. The Central Banks of Sweden (1668) and England (1694) were established in the late seventeenth century, Thereafter, Central Banks spread rather slowly in different parts of the world over the eighteenth century. In the nineteenth century, however, several countries in Europe such as France (1800), Finland (1811), the Netherlands (1814), Austria (1816), Norway (1816), Denmark (1818), Portugal (1846), Belgium (1850), Spain (1874), Germany (1876), Italy (1893), and Japan in Asia (1882) established Central Banks.

3. With the emergence of a number of nation states in the wake of disappearance of colonial regimes, central bank mandates in many developing countries, including that in India, transcended well beyond typical central banking functions so as to encompass a wide range of developmental pursuits. Consequently, Central Banks in developing countries broadened their mandate beyond the traditional functions of issuing currency and managing the government debt to encompass developmental roles like ensuring economic recovery and promoting growth.

4. In the wake of growing concerns about inflation, monetary policy formulation assumed critical importance. Accordingly, in the late twentieth century, development of global financial markets and proliferation of financial instruments coupled with episodes of financial crises brought to the fore central banks' concern for price stability, financial stability and risk management.

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5. Central banking was initially practiced with an array of informal norms, conventions and self-imposed codes of conduct. These were later formalized into theory and institutionalized in to laws that apply to today's central banking institutions. These laws have been amended and modified periodically to suit the evolving financial structures in most countries.

6. Founded in 1694 under a Royal Charter of the United Kingdom, the Bank of England, known as the old lady of Threadneedle Street, acted as the government's bank and the UK's central bank It issued bank notes, controlled the UK gold reserves and, since 1997, has set official interest rates. The Bank of England is the second oldest central bank in the world after the Swedish Riksbank, which was founded in 1668.

7. During the first world war, the Bank played a major role in managing the government borrowing. The Bank of England was nationalised in 1946 and acted as the Treasury's adviser, agent of and debt manager to Government.

8. The Federal Reserve System (also known as the Federal Reserve or simply the Fed) is the central banking system of the United States.
It was established in 1913, following the enactment of the Federal Reserve Act. It came in to existence in response to a series of financial panics (particularly the panic of 1907) that showed the need for central control of the monetary system if crises are to be averted.

The Federal Reserve Act establishes three key objectives for monetary policy viz., maximizing employment, stabilizing prices, and moderating long-term interest rates.

After the First World War, the role of Central Banks became even more important as the role of supervising the business of private commercial banks was added and lender-of-last-resort function to stabilize the banking system during financial panics was strengthened.

The First World War also led to the Central Banks' increasing involvement in extending credit to the respective governments. In order to handle their new role as managers of government debt, Central Banks were allowed to trade government paper in the open market and were entitled to develop open market policy instruments.

- Since 1933, in the US and shortly after the Second World War in Germany, central banks were empowered to impose the stipulation of maintenance of minimum reserve requirements by banks.
- This stipulation provided an important and direct tool of monetary management for central banks.

- During global crises such as the Great Depression of the 1930s, the mandate given to most central banks included monetary stability, promotion of full employment and maximization of growth.
- The role of central banks was thus enhanced successively after every crisis.

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- The functions of a Central Bank can be broadly categorized into monetary policy functions, banker to the banks, banker to the government and developmental functions.
- The functions of note issue and maintenance of internal and external value of currency also evolved as the key functional areas of Central Banks.
- The responsibility of promoting growth was subsequently added to it.
- The afore-mentioned set of functions formed the core modern central banking functions.

- Central Banks also realized the close relationship between the financial development and economic development.
- Accordingly, provision of finance to the productive sectors of the economy promotes economic development.

REASONS FOR PROLIFERATION OF CENTRAL BANKS

- The reasons for the origin and proliferation of central bank of course, lay in the need for an appropriate authority to be entrusted with the function of note issue;
- need for an agency to act as a banker and lender to the government, and finally the need for an agency to regulate and supervise the banks and financial entities and
- to serve as a lender of last resort to banks; and
- central banks were regarded as the most appropriate institutions to perform these responsibilities.

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CONFLICTING ROLE AND RESPONSIBILITIES OF CENTRAL BANKS

- The role of a central bank as banker to the Government gained renewed relevance particularly in times of war.
- The current professional thinking, however, is that the role of a central bank as a debt manager in a sense is conflicting with the core objective of central bank, namely, price stability.
- As debt manager of Government, it was observed that central banks financed Government deficits partially.
- This process of extending credit to Government puts pressure on monetary policy of central banks as they need to create excess money to meet Government needs.
- Another issue relating to central banks role is that of its function of regulation and supervision of the financial entities.
- This issue arises in the wake of the observation that the roles of a regulator and supervisor are divergent and entrusting these roles to a single authority, namely, the central bank, could lead to conflict of interest.
- The core of modern central banking also consists of development of financial markets and instruments, financial regulation and supervision, management of government debt, administration of payment and settlement systems and maintenance of the external value of currency.
- With the objective of dealing with increasing complexities in financial products and instruments and for improving the operational procedures and practices, research activities have been given considerable importance in analyzing the economic environment and devising suitable strategies.

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DEVELOPMENT OF CENTRAL BANKS IN DEVELOPED AND DEVELOPING COUNTRIES

There are marked differences in the development of Central Bank functions as between developed and developing countries.

DEVELOPED COUNTRIES

- The developed countries are characterized by a well-diversified and strong financial super structure.
- They are advanced in the sense of both financial widening and financial deepening.
- Hence, the monetary transmission processes of central banks are smooth and fast.
- The policy signals are transmitted quickly. Any change in interest rates by central banks in advanced economies triggers an immediate response from the banking system and the financial markets and sets the move for reallocation of resources
- In the developed countries, there is a preponderant use of cheques/drafts rather than currency as a means of payment mechanisms. Hence, the currency management of central banks tends to be minimal as compared to developing countries.

DEVELOPING COUNTRIES

- In developing countries, currency forms a major proportion of money supply in view of the fact that a vast majority of population use currency as a means of payment.
- The currency to deposit ratio is generally very high in developing countries as compared to developed countries.

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- As currency forms a major chunk of money supply, management of currency by the central bank becomes complex and intricate.
- The developing countries are characterized by poor financial infrastructure and the banking network is sparsely spread.
- Central Banks of such countries need to expend efforts at creating financial infrastructure for channelizing savings for investment purposes.
- Further, as compared to developed countries, the developing countries are faced with the problem of existence of informal markets.
- These informal markets operate independently of the organized money market.
- This considerably weakens the monetary transmission processes in developing countries as interest rate signals from the central bank generally do not affect the operations of informal markets.
- In developing countries like India, central banks came into existence to promote the spread of commercial banks and other channels of credit flow.
- The principal reason for the genesis of the central banks in several developing countries is that they should primarily play a developmental role.

CONCLUSION

In view of the above, it can be concluded that central banks have evolved in accordance with the specific requirements of the economies in which they are situated and in response to the nature of demands made on them. Their roles expanded as the situation unfolded and theory of central banking began to emerge simultaneously.

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QUESTION AND ANSWER

Q1. ________ was the prime consideration for constitution of many of the early Central Banks.
Ans: war finance

Q2. The Federal Reserve Act establishes three key objectives for monetary policy viz., maximizing employment, __________, and moderating long-term interest rates.

Ans: stabilizing prices

Q3. Central Banks also realized the close relationship between the ___________ and_____________.

Ans: financial development, economic development

Q4. One of the issues relating to central banks role is that of its function of regulation and supervision of the financial entities. (true/false)

Ans: true

Q5. The lender of last resort is one of the functions of ________ .

Ans: central bank

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Q6. __________ and ____________ objectives of monetary policy of US Federal Reserve are referred to as dual mandate.

Ans: Maximizing employment & stabilizing prices

Q7. Central Banks of ___________ countries need to expend efforts at creating financial infrastructure for channelizing savings for investment purposes.

Ans: Developing countries