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FUNCTIONS OF A CENTRAL BANK

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CENTRAL BANKING

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FUNCTIONS OF A CENTRAL BANK

- The functions of a Central Bank vary in nature and with the stage of economic development of the country where the Central Bank is situated, the nature of mandate it has been given and the degree of operational independence it enjoys.
- The issue of operational independence gained relevance as central banks are given the responsibility of maintaining price stability as the core objective of monetary policy.

The important functions of central banks include.

- Banker to Government,
- Bankers' bank,
- Holding monopoly of note issue,
- Maintenance of internal and external value of the currency, facilitating the development of payment and settlement system beside undertaking other development activities.
- The task of promotion of growth and development is an important function in the case of central banks of developing countries. Accordingly, central banks have assumed functions like development of markets, institutions, and communication policies.
- With the development of the financial sector, the lender-of-last-resort function has grown to encompass the role of a regulator and supervisor.
- Central banks have now adopted financial stability as an additional objective of policy.

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BANKER TO GOVERNMENT

- One of the primary functions of central banks was to finance the Governments.
- This is because many countries faced problems of financing their budget deficits.
- They felt the need to have the support of another agency which could effectively manage the Government finances.
- The Central Banks are in a unique position to discharge this function. In the earlier years, central banks created money against gold backing.
- Over the years, the eligible assets for monetary expansion got enlarged and included gold, foreign exchange reserves, Government Securities and Government paper/bills.

Government maintains their accounts with the Central Banks and meet their fund (borrowing) requirements by placing bills with the Central Bank. The Central Bank then issues note against these bills and credits an amount equivalent to the nominal/ agreed value of bills to the account of the Government maintained with it. This is generally termed as the Central Bank's credit to Government and the money thus created by the Central Bank is termed as monetization of Government debt.

- As a part of the market borrowing program, Central Banks issue Government securities.

- ***Open market Operation (OMO)*** is an important policy tool to influence the level of liquidity in the economy. It involves the purchase and sale of Government securities. The purchase of securities by Central Banks will increase the liquidity in the system and the sale of Government securities will result in the reduction/withdrawal of liquidity from the system.

- It has been generally observed that in the wake of budgetary imbalances, Governments tend to depend heavily on Central Banks' financing.
- Central Banks may very often land in dilemma when they face conflicting objectives such as whether to tighten liquidity based on monetary policy considerations or to ease liquidity to ensure success of borrowing program.
- Another area of concern relates to the pressure Governments may exert on central banks to artificially depress the interest rates to contain the burden of interest payment on government debt.

BANKER TO BANKS

- Another important function of the Central Banks across the globe is to act as bankers to banks.
- In this the Central Banks are entrusted with the task of maintaining financial stability.
- They act as lender of last resort in times of crisis.
- Over the years, the role of Central Banks has expanded considerably since banks are not merely purveyors of money but also creators of money.
- Banks create money through the process of lending.
- In the case of bank lending, the borrower is usually given a credit limit against which cash can be drawn or cheques can be issued to meet payment obligations.
- The receivers of cheques may deposit the same in the same bank or with another bank.
- As such the receiving bank's deposit balances will go up. The receiving bank would then be able to extend credit

commensurate with the increase in its deposit balances. For the system, this process sets in motion multiple credit creation.

Let's assume that the bank is required to keep 20% of the deposits on its reserves in case the customers want to withdraw their funds. someone depositing 1000 in a commercial bank.

People	Primary deposit	Reserves(r=20%)	Credit Creation
Person A	1000	200	800
Person B	800	160	640
Person C	640	128	512
Person D	512	102	410
...	...	...	...
...	...	...	...
Total	5000	1000	4000

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LENDER-OF-LAST-RESORT

- Central Banks perform the task of rescuing banks whenever they face crisis situations.
- A banking crisis is an event in which many or even all banks in the banking system face sudden demand from their creditors/depositors.
- Lender-of-last-resort function is that to prevent bank panics, Central Bank should provide liquidity to solvent
- Thus, through lender-of-last resort function, the Central Bank may ensure stability of the banking sector, which is prone to disturbances, with a view to avoiding consequences to the real sector.

MONETARY POLICY FUNCTIONS

- Monetary policy functions form the core of central banking operations and constitute one of the key functions of almost all central banks.
- Overall, the two important factors contributing to monetary expansion are:
- The net central bank credit to Government and
- The net foreign exchange reserves position.
- Another factor contributing to monetary expansion has been the net credit extended by the central bank to the commercial sector.
- These variables are termed as sources of change in money supply.
- Central Banks have equipped themselves with appropriate instruments for carrying out their monetary policy function.

- One such measure is the stipulation that the commercial and other banks to maintain a certain proportion of their demand and time liabilities with the central bank.
- These reserves could be varied by central banks depending upon emerging economic scenario.
- This policy instrument is termed as cash reserve ratio.
- The price stability objective has emerged as a dominant objective of monetary policy in many countries.

- **Digital currencies** have attracted strong interest in recent years and there is a feeling in some quarters that they bear a potential to become widely adopted for use in making payments. Public authorities and central banks around the world are closely monitoring developments in digital currencies and studying their implications for the economy, the financial system and central banks.
- A digital currency is a means of payment that only exists electronically. Like traditional money (such as banknotes), they can be used to buy physical goods and services. The most well-known privately issued digital currency is Bitcoin, but other examples include Lite Coin, Ethereum and Ripple.

CURRENCY ISSUE AND MANAGEMENT

- The primary function of a central bank is the monopoly of note issue. Before central banks took over the currency issue function, several private banks used to perform this function.
- This led to circulation of numerous currencies with varying degrees of acceptability.

- There was no control either on the quantum of currency issue or on the management of such issue in accordance with the requirements of the economy at large.
- Accordingly, this dispensation not only created confusion in the minds of people but also led to loss of credibility with respect to currency validity.
- Therefore, for ensuring uniformity in note issue across the country and to uphold its credibility and authenticity as an easy means of payment and settlement mechanism, Governments came to entrust the performance of this function to central banks.
- The role of currency management would differ between the developed and developing countries.
- This is because, as development takes place, the proportion of currency in total money supply declines and the use of alternative instruments such as cheques, drafts, cards etc., increases. The developing countries are characterized by prevalence of barter transactions, significant diversity in socio-economic development across regions and across income groups.

PAYMENT AND SETTLEMENT SYSTEMS

- Payment and settlement systems play an important role in facilitating financial transactions.
- Financial transactions involve both receipts as well as payments. Settlement of transactions in cash is never an issue.
- But the other forms of payment involve intermediaries and unless both ends of the transaction are complete, a transaction may not be settled.
- Clearing Houses emerged as the nerve centres for facilitating settlements of funds.

- As the volume of transactions and the instruments rose, the Clearing Houses faced problems in terms of ensuring quick settlements. Central banks took over the responsibility of clearing houses and payment and settlement function so as to ensure quick settlements in a safe and secure environment by setting certain rules for the participating banks.
- The structure of the payment and settlement systems vary across Central Banks.

Broadly, there are three variants of organizational structure followed wherein.

(a) the entire range of operations viz., the regulatory and operational aspects of clearing function are managed by Central Banks,

(b) the regulatory aspects are looked after by the Central Banks; the clearing operations are managed by private entities and

(c) the regulatory aspects are with the Central Banks, the clearing operations are shared by the Central Bank and the participating entities such as commercial banks etc.

MAINTAINING INTERNAL VALUE OF CURRENCY

- Apart from acting as a medium of exchange and unit of account, money also functions as a standard of deferred payment and as store of value.
- As a standard of deferred payment, money acts as a unit of account in terms of which future payments are stipulated.
- This applies to payments of interest, rents, salaries, pensions, insurance premium etc.

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- Large fluctuations in the value of money; inflation or deflation; would make money not only a poor measure of value, but also a poor standard of deferred payment.
- Thus, the task of monetary management to ensure the stable value of money becomes socially important.
- Money also serves as a store of value i.e., members of public hold their wealth in the form of money.
- This function of money is derived from the use of money as a medium of exchange in a two-fold manner.
- the use of money as a medium of exchange decomposes a single barter transaction in to two separate transactions of purchase and sale.
- The issue that the role of central bank as monetary policy authority with the major objective of price stability and its role as a banker to Government, performing the task of public debt management is conflicting in nature has been widely discussed.
- The relevance of this issue becomes evident particularly in the context of developing countries.
- Since the saving-investment gap in these countries remain high, Governments need to undertake developmental activities in order to increase their income level.
- In the process, they tend to incur larger budget deficits.
- In order to accommodate large Government borrowing, central banks often use regulatory measures granted to them by the statute. An important tool of monetary policy that facilitates the conduct of market borrowing program of central banks is the statutory liquidity ratio (SLR)
- During the 1970s and 1980s, the theoretical underpinnings of monetary policy framework centered round the inter-links between money, output, and prices. Given the levels of any two

variables, the level of the third variable could be determined automatically.

For example, the assumption of a certain rate of growth in the economy in a climate of stable level of prices implies that the monetary stock should be at an appropriate level to facilitate such stipulated growth.

- A country adopting inflation targeting has to select the relevant price index that is to be targeted. Some countries have adopted the Consumer Price Index (CPI) for this purpose.
- Alternately, they may target core inflation.
- Developing countries generally have relatively higher rates of inflation. In these countries predicting future inflation is often uncertain.

QUESTION AND ANSWER

Q1. __________ is an important policy tool to influence the level of liquidity in the economy. It involves the purchase and sale of Government securities.

Ans: Open market Operation (OMO)

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Q2. In the case of bank lending, the borrower is usually given an ________ against which cash can be drawn or cheques can be issued to meet payment obligations.

Ans: credit limit

Q3. _________ money acts as a unit of account in terms of which future payments are stipulated.

Ans: deferred payment

Q4. Monetary policy framework centred round the inter-links between money, output and _________.

Ans: prices

Q5. Consumer Price Index (CPI) adopted by Some countries have _________ targeting.

Ans: inflation

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MAINTENANCE OF THE EXTERNAL VALUE OF CURRENCY

- The maintenance of the external value of money received utmost importance of central banks in many economies even in the seventeenth century.
- This function assumed importance in view of its implications for international trade and finance.
- In order to ensure credibility in international transactions, some countries started linking their currencies to gold.
- The gold standard regime ensured that the value of the currency rose with an increase in gold reserves and decreased with a decrease in the reserves.
- Such exchange rate movements along with gold reserves were not necessarily conducive to output growth. Besides, there is likelihood of transmission of inflation or deflation experienced in one country to another country through this process.

For example, if a unit of currency in country one purchases two units of a given commodity whereas the same unit purchases one unit of the commodity in country two, then the purchasing power of country one is twice that of country two.

- The rationale and practices followed in managing the exchange rate differs from country to country and over time in the same country.
- During colonial rule in the seventeenth and eighteenth centuries, the ruling countries used the exchange rate mechanism to promote their own trade and investment.
- The I.M.F, introduced the facility of Special Drawing Rights (SDRs) in 1967 with a view to manage global liquidity.
- The need for creation of SDRs arose in the wake of the inadequacy of the arrangements regarding the borrowing of hard currencies by deficit countries

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- A currency crisis is a general loss of confidence in the currency.
- A currency crisis refers to a situation where market players' expectations that the prevailing level of exchange rate is unsustainable, gives rise to speculative activities that build up pressure, forcing official devaluation or revaluation of the currency.

SDR

- Special drawing rights were originally introduced in 1969 by the IMF.
- At this time, the main purpose of creating SDRs was for use as a supplementary foreign exchange reserve.
- This was due to a lack of US dollars and gold, which at the time were the main assets held in foreign exchange reserves.

The Asian Economic Crisis of 1997

- The crisis was unanticipated and has engulfed the entire Asian Region.
- The crisis essentially concerns five countries - Indonesia, Korea, Malaysia, the Philippines, and Thailand, although Hong Kong, Singapore, and Taiwan were also affected to some extent by it for a brief period.
- The Asian Economic crisis is unlike other crises witnessed in Mexico, viz., the currency crisis witnessed in 1994.
- The Asian crisis was a combination of currency and financial sector crisis with wide ranging effects on the real economy and on the international financial markets.

- The Reserve Bank of India and the Government of India has been expending continuous efforts at implementing the Basel principles as well as the IMF standards and Codes.
- The appreciable initiatives taken by the authorities in India resulted in shielding the economy from the impact of the recession of 2008 and in hastening the process of recovery.

REGULATION, FACILITATION AND SUPERVISION OF FINANCIAL SYSTEM

- Central Banks started taking over the regulatory and supervisory functions of the financial systems as the banks and other financial entities play a significant role in providing finance for developmental purposes and failure of banks due to systemic or other reasons could cause tremendous damage to the economic system at large.
- Banks extend credit to various sectors of the economy based on the quantum of deposits mobilized by them from the Public.
- They run the risk of default and there exists a need to ensure the safety and security of deposits placed by the Public with the banks, on the one hand, and to ensure that the deposits mobilized are directed towards the productive sectors of the economy and not diverted into risky ventures.
- Thus, central banks need to protect the interests of depositors while simultaneously ensuring that the functioning of banks is in accordance with the best interests of the economy.
- Banks balance sheets are important from the monetary management point of view. It was seen earlier that while creating credit, banks simultaneously generate deposits.

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- Central Banks role as a regulator has evolved gradually over the years. Initially, Central Banks through statutory regulation sought to protect the interests of depositors.
- The primary justification for banking supervision is that it aims to limit the risk of loss to depositors and thus maintains public confidence in banks.
- Bank supervisors seek to ensure that banks are financially sound, well managed and do not pose a threat to the interests of their depositors. In pursuing these objectives supervisors base their judgments on three aspects, viz.,
    i. how much risk each bank is undertaking,
    ii. what resources, tangible (e.g., capital, liquidity) or intangible (e.g., quality of management and control systems) are available to manage that risk, and
    iii. whether the identified level of resources is sufficient to manage/balance the risk.
- The risk-based supervision framework developed by the Basel Committee involves identification of key risks, their level and the areas where these are likely to surface.
- After identifying these risks, a comprehensive supervisory framework with appropriate resources is assembled to mitigate the risks.
- The required resource package for mitigating these risks is dependent on the level and intensity of the perceived risks.

Risk-Based Supervision - Country Practices

- The Risk-Based Supervision (RBS) is based on the principle of differentiated supervision.

- A number of countries, both from advanced and emerging market economies group have adopted this risk-based supervisory approach. Under this approach, the regulator prepares a risk map of an institution taking into account various external threats.
- The regulator also develops Risk Mitigation Programs (MP) including diagnostic, monitoring, preventive and remedial tools, which are designed to be outcome-oriented.
- In India, the idea to move towards risk-based supervision of banks was first mooted in 2000.
- Based on the experience gained, the RBS process was revisited in October 2005 to make the risk profiling exercise more risk-sensitive, objective and user-friendly.
- A new rating framework has been designed for proper risk assessment and risk aggregation.
- Smooth implementation of RBS framework for banks could be considered as a precursor to the New Capital Accord which would enable Indian banks to comply with the Basel II norms in an improved way.
- This would strengthen the risk management practices of Indian banks and shield them against any possible crisis.

Core Principles for Effective Banking Supervision

The core principles for effective banking supervision are a framework of minimum standards for sound supervisory practices and are considered universally applicable.

The principles are broadly categorized into two categories:

1. the first group (Principles 1 to 13) focus on powers, responsibilities and functions of supervisors, while

2. the second group (Principles 14 to 29) focus on prudential regulations and requirements for banks.

Supervisory powers, responsibilities and functions

Principle 1 - Responsibilities, objectives and powers: An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups.

Principle 2 - Independence, accountability, resourcing and legal protection for supervisors; The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources.

Principle 3 - Cooperation and collaboration: Laws, regulations or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors.

Principle 4 - Permissible activities: The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined.

Principle 5- Licensing criteria: The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria.

Principle 9-Supervisory techniques and tools: The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach and deploys supervisory resources on a

proportionate basis, taking into account the risk profile and systemic importance of banks.

Principle 10 - Supervisory reporting: The supervisor collects, reviews and analyses prudential reports and statistical returns from banks on both a solo and a consolidated basis, and independently verifies these reports through either on-site examinations or use of external experts.

Prudential regulations and requirements

Principle 14 - Corporate governance: The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organisational structure, control environment, responsibilities of the banks' Boards and senior management, and compensation.

Principle 15 - Risk management process: The supervisor determines that banks have a comprehensive risk management process to identify, measure, evaluate, monitor, report and control or mitigate all material risks on a timely basis and to assess the adequacy of their capital and liquidity in relation to their risk profile and market and macroeconomic conditions.

Principle 16 - Capital adequacy: The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates.

Principle 17- Credit risk: The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile and market and macroeconomic conditions.

Principle 22 - Market risks: The supervisor determines that banks have an adequate market risk management process that takes into account

their risk appetite, risk profile, and market and macroeconomic conditions and the risk of a significant deterioration in market liquidity.

Principle 23 - Interest rate risk in the banking book: The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate interest rate risk in the banking book on a timely basis.

Principle 24 - Liquidity risk: The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both for banks that reflect the liquidity needs of the bank.

Principle 28 - Disclosure and transparency: The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies and corporate governance policies and processes.

FINANCIAL STABILITY

- financial stability as the 'prevalence of a financial system, which is able to ensure in a lasting way and without major disruptions, an efficient allocation of savings to investment opportunities'.
- This broad definition is important because of its perception that an individual bank failure or every large swing in asset prices does not necessarily mean financial instability.
- According to Y.V. Reddy, financial stability is said to exist if the financial system is characterized by uninterrupted financial transactions, maintains a level of confidence in the financial system and amongst all the participants and stakeholders, and

there is an absence of excessive volatility that unduly and adversely affects real economic activity.

PROMOTIONAL FUNCTIONS TO SUPPORT GROWTH AND OTHER NATIONAL OBJECTIVES

- Promotion of growth is at the centre of all economic policies.
- In the broad sense of the term, promotion of growth could qualify as a developmental function universally performed by Central Banks.

DEVELOPMENT OF FINANCIAL MARKETS AND INSTITUTIONS

The challenges before the Central Banks in developing countries are enormous;

- First, they are constrained by the prevailing market conditions.
- Second, as leaders of the financial sector they have to adapt their policies to suit the changing structure of the economy and proactively modify the financial structure itself to promote development.

CENTRAL BANK COMMUNICATION POLICIES

Central Banks communicate their views and policies in the form of monetary and credit policy announcements and various reports that they publish.

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QUESTION AND ANSWER

Q1. SDRs stands for _____________?

Ans: Special Drawing Rights

Q2. A ______ refers to a situation where market players' expectations that the prevailing level of exchange rate is unsustainable, gives rise to speculative activities.

Ans: currency crisis

Q3. The main purpose of creating SDRs was for use as a supplementary __________.

Ans: foreign exchange reserve

Q4. The risk-based supervision framework developed by the _______involves identification of key risks, their level, and the areas where these are likely to surface.

Ans: Basel Committee

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Q5. The core principles for effective banking supervision are broadly categorized into two categories _________ and ________.

Ans: powers, responsibilities and functions of supervisors and prudential regulations and requirements for banks.