

FACULTY OF JURIDICAL SCIENCES

Lecture-17



CENTRAL BANK

A central bank is a financial institution given privileged control over the production and distribution of money and credit for a nation or a group of nations. In modern economies, the central bank is usually responsible for the formulation of monetary policy and the regulation of member banks.

Central banks are inherently non-market-based or even anti-competitive institutions. Although some are nationalized, many central banks are not government agencies, and so are often touted as being politically independent. However, even if a central bank is not legally owned by the government, its privileges are established and protected by law.

The critical feature of a central bank—distinguishing it from other banks—is its legal monopoly status, which gives it the privilege to issue banknotes and cash. Private commercial banks are only permitted to issue demand liabilities, such as checking deposits.

- A central bank is a financial institution that is responsible for overseeing the monetary system and policy of a nation or group of nations, regulating its money supply, and setting interest rates.
- Central banks enact monetary policy, by easing or tightening the money supply and availability of credit, central banks seek to keep a nation's economy on an even keel.
- A central bank sets requirements for the banking industry, such as the amount of cash reserves banks must maintain vis-à-vis their deposits.
- A central bank can be a lender of last resort to troubled financial institutions and even governments.

Although their responsibilities range widely, depending on their country, usually central banks' perform duties falls into following areas-

First, central banks control and manipulate the national money supply: issuing currency and setting interest rates on loans and bonds. Typically, central banks raise interest rates to slow growth and avoid inflation; they lower them to spur growth, industrial activity, and consumer spending. In this way, they manage monetary policy to guide the country's economy and achieve economic goals, such as full employment.

Second, they regulate member banks through capital requirements, reserve requirements (which dictate how much banks can lend to customers, and how much cash they must keep on hand), and deposit guarantees, among other tools. They also provide loans and services for a nation's banks and its government and manage foreign exchange reserves.

Finally, a central bank also acts as an emergency lender to distressed commercial banks and other institutions, and sometimes even a government. By purchasing government debt obligations, for example, the central bank provides a politically attractive alternative to taxation when a government needs to increase revenue.

FUNCTIONS OF CENTRAL BANK

Currency regulator or bank of issue: Central banks possess the exclusive right to manufacture notes in an economy. All the central banks across the world are involved in issuing notes to the economy.

This is one of the most important functions of the central bank in an economy and due to this the central bank is also known as the bank of issue.

Earlier all the banks were allowed to publish their own notes which resulted in a disorganized economy. To avoid this situation the government around the world authorized the central banks to function as the issuer of currency, which resulted in uniformity in circulation and balanced supply of money in the economy.

Bank to the government: One of the important functions of the central bank is to act as the bank to the government. The central bank accepts deposits and issues funds to the government. It is also involved in making and receiving payments for the government. Central banks also offer short term loans to the government in order to recover from bad phases in the economy.

In addition to being the bank to the government, it acts as an advisor and agent of the government by providing advice to the government in areas of economic policy, capital market, money market and loans from the government.

In addition to that, the central bank is instrumental in formulation of monetary and fiscal policies that help in regulation of money in the market and controlling inflation.

Custodian of Cash reserves: It is a practice of the commercial banks of a country to keep a part of their cash balances in the form of deposits with the central bank. The commercial banks can draw that balance when the requirement for cash is high and pay back the same when there are fewer requirements of cash.

It is for this reason that the central bank is regarded as the banker's bank. Central bank also plays an important role in the credit creation policy of commercial banks.

Custodian of International currency: An important function of the central bank is to maintain a minimum balance of foreign currency. The purpose of maintaining such a balance is to manage sudden or emergency requirements of foreign reserves and also to overcome any adverse deficits of balance of payments.

Lender of last resort: The central bank acts as a lender of last resort by providing money to its member banks in times of cash crunch. It performs this function by providing loans against securities, treasury bills and also by rediscounting bills.

This is regarded as one of the most crucial functions of the central bank wherein it helps in protecting the financial structure of the economy from collapsing.

Clearing house for transfer and settlement: Central bank acts as a clearing house of the commercial banks and helps in settling of mutual indebtedness of the commercial banks. In a clearing house, the representatives of different banks meet and settle the interbank payments.

Controller of credit: Central banks also function as the controller of credit in the economy. It happens that commercial banks create a lot of credit in the economy that increases the inflation.

The central bank controls the way credit creation by commercial banks is done by engaging in open market operations or bringing about a change in the CRR to control the process of credit creation by commercial banks.

Protecting depositor's interests: Central bank also needs to keep an eye on the functioning of the commercial banks in order to protect the interests of depositors.