Mohamed Khaider University, Biskra

Faculty of Economics, Commerce and Management Sciences

Commerce Department

Module: English
Branch: Commercial Sciences
Level: Second year Bachelor

Lecture 05: Central Bank

In this unit, you will study the meaning and functions of a central bank, the difference between a central bank and commercial banks.

Objectives

After reading this unit, you should be able to:
- Define what a central bank is
- Identify the main differences between a central bank and a commercial bank
- list the various functions performed by a central bank

1- Introduction

A central bank is the apex institution of a country's monetary and financial system. It plays a leading role in organizing, running, supervising and regulating the activities of commercial banks and other financial institutions in the country. The design and conduct of monetary and credit policies **are** its special responsibilities. Hence, the central bank plays a very important role in the balanced development of a modem economy.

2- What is a Central Bank?

All developed and most of developing countries have a central bank. However, in most countries the central bank is a 20th century financial institution. The Bank of England, the oldest central bank in the world, was set up in 1694 as a joint stock company by-an Act of Parliament. The Federal Reserve Bank in USA was established in 1913. In India, the Reserve Bank of India was set up on April I, 1935 under the Reserve Bank of India Act, 1934.

The central bank occupies a pivotal position in the monetary and banking structure of every country. It is the highest monetary institution and a leader of the financial system of the 'country. However, it is not easy to give any precise and accurate definition of central bank. The definition of a central bank is largely derived from its functions. As functions of central banks vary between countries and over time, so does the definition of a central bank. Various economists have defined central bank by laying emphasis on its different functions like control of credit, lender of the last resort, note issue, regulation of currency and credit, and stability the value of money in the interest of general public welfare?.

Different economists have defined central bank differently;

- CentraI Bank is that bank which controls credit

- The central bank is the lender of the last resort

-The central bank has been defined as the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in the country

- The central bank is that bank the essential duty of which is maintenance of stability of monetary standard .

- It is an institution charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of the general public welfare.

We may conclude that central bank is that highest financial institution of a country whose main function is to regulate, coordinate, integrate and guide the monetary and banking structure so as to realize certain desired goals of national and public welfare

3- Distinction between *a Central* Bank and *Commercial* Banks

***Central* Bank**	***Commercial* Banks**
The prime objective is the economic interest of the nation	aim to earn maximum profit for its shareholders,
It is an organ of the government.	are joint stock firms
Its actions are, therefore, closely coordinated with those of the other departments of the government, particularly with the departments of finance, industry and foreign trade.	are privately owned and privately managed.
The central bank**,** deals with the public only indirectly through the commercial banks and money market.	Accepting deposits from general public and accommodating regular commercial customers with discounts and advances - Direct dealing with the general public-
The central bank has the monopoly power of issuing currency notes	Money Creation
Regulating the working of the commercial banking system of the country	they operate under the supervision and within the policy framework of the central bank
Only one central bank	Generally there are a number of comrnercial banks

4- Functions Of a Central Bank

The central bank should essentially perform the following functions:

- Monopoly of Currency Note Issue. This function is so important that until the beginning of 20th century the central bank was known as the bank of issue. In the early days of banking, even commercial banks had the right to issue notes. But later on this practice was done away, and the power of issuing currency notes is entrusted to the central bank for the following reasons:

* It brings about uniformity in Currency note issue, which is so important for the development of trade and industry.

* It ensures reasonable supply of money in the economy and avoids any possibility of over-issue by individual banks.

* It tends to render its control over the unwarranted credit expansion by the commercial banks.

* It ensures better elasticity in note issue. It is because there may be careless expansion of money supply by commercial banks. Even the government may be tempted to increase its revenue by over-issue of currency notes which may lead to inflation in the economy

- Banker, Agent and Financial Adviser to the State: The central bank functions as the custodian of government funds. It accepts deposits on behalf of the government, and maintains banking accounts of both the government department and government enterprises. It advances short-term loans to the government in anticipation of collection of taxes or rising of loans from the public. As an agent of the government, it conducts transactions on behalf of the government involving the purchases or sales of foreign currencies, management of national debt, and also sale and purchase of government securities in the open market. In the role of financial adviser, central bank gives much sought-after advice to the government on important matters relating to economic policy.

- Bankers' Bank; All commercial banks are required to keep certain percentage of their cash reserves with the central bank. This arrangement is due to some reasons;

* it ensures high degree of public confidence in the banking system

*it enables the central bank to provide additional funds to such member banks which are in temporary financial difficulty.

* it forms the basis for highly liquid and more elastic credit structure

* it helps central banks to have an effective control over the credit creation by commercial banks

- **Custodian of Gold and foreign currency reserves;** This right of central bank enables it to exercise a reasonable control over key foreign currency, reserves which is very vital to maintain the country's international liquidity position at a safe margin. The central bank may buy its home currency in the foreign exchange market when its value is declining, and vice verso.

- **Controller of Credit*;*** there should be some authority to control and regulate the credit creation activity of commercial banks.

- **Bank of *Central* Clearance, *Settlements and* Transfer;** The central bank keeps cash balances of all commercial banks, it is quite easy for member banks to adjust their claims against each other in the books of central bank. Since commercial banks keep their surplus funds as deposits with the central bank, it is far easier lo effect clearance and settlement of claims between them by making transfer entries in their books of accounts maintained with the central bank.

- **Lender of the last Resort:** This implies that the central bank assumes the responsibility of meeting directly or indirectly all reasonable demands of commercial banks for funds in times of difficulty anti financial crisis