CHAPTER-I

GENESIS AND FUNCTIONS
OF THE BANKING INSTITUTIONS
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A bank\(^1\) is an institution, which deals in money.\(^2\) Broadly speaking banks draw surplus money from the people who are not using it at the time, and under those who are in a position to use it for productive

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\(^1\) Any organisation engaged in any or all of the various functions of banking, i.e., receiving, collecting, transferring, paying, lending, investing, dealing, exchanging, servicing (safe deposit, custodianship, agency, trusteeship) of money and claims to both domestically and internationally. In its more specific sense, however, the term bank refers to institutions providing deposit facilities for the general public. Such institutions may be classified into two broad groups: (1) Commercial banks and their Central Banks; and (2) Non-commercial bank institutions. Included in the latter group are such institutions as the savings and loan associations, mutual savings banks, and credit unions. These institutions are often referred to as the thrift institutions although Commercial banks also provide savings and time deposit accounts.


\(^2\) Anything which people use as a medium of exchange. Originally the word money applied only to coins and even as late as the nineteenth century customary usage called for the word currency when it was intended to include any kind of paper money as well. In Great Britain the term paper currency applied to bank notes, while in the United States the same term applied not only to government notes, bank notes not being considered currency. Much confusion of thought naturally resulted and was compounded by introduction of the term check currency are deposit currency when that element began to achieve that predominant role as an exchange medium. Since the close of World War-I there has developed a wide, though not universal, acceptance of the League of the Nations' official use according to which money includes not only coin but also government notes and certificates, bank notes, and demand deposits in banks on various occasions, in early history certain commodities, such as bearer skins and tobacco have been used as exchange in media, but they seldom were actually called money. Certain short term financial instruments, such as bankers' acceptance and commercial paper are traded in market commonly called 'the money market', but the instruments themselves do not usually serve as exchange media and no one thinks of them as money. In international trade uncoined gold or gold bullion is an exchange medium in the sense that it is often used as a means of settling balances, but in this connection the term 'money' is applied figuratively. Money is basically a function, but the standard or commodity selected to fulfill the function may perform well or poorly.

For further details see *Collier's Encyclopedia*, (New York, Macmillan Education Company, 1983), pp.443-449.
purposes. They are an integral part of the modern money economy; their activity is closely connected with the needs of reproduction. Since banks are at the centre of economic life and service the interests of producers, they act as intermediaries in relations between industry and trade, agriculture and the population. Banks are not an attribute of a separate economic region or any one country. The sphere of their activity has neither geographical nor national boundaries. They possess colossal financial power and considerable monetary capital.

Modern banks have developed from very small beginnings. The earlier bankers were Goldsmiths. In Europe, they were also moneychangers. As the Goldsmiths dealt in precious metals they had to arrange for the safety of their treasure. People with surplus money or Gold gradually began to deposit their precious metals with such persons. This in a primitive way was the beginning of what is called deposit banking. The Goldsmiths would issue receipts for the metal received as everyone believed in their integrity and their ability to honour these receipts, through experience in course of time, these receipts began to pass from hand to hand in payment of obligations instead of being first converted into gold. These receipts were the earlier bank notes.

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3 Dewett, n.3,p.394.
The Goldsmiths soon found that only a small proportion of the metal deposited with them was taken out by the depositors. They therefore, began to make profit by lending a part of these deposits. In this lending, it was not always gold that they gave but issued their receipts, which would pass among the people as if they were gold. Thus the banks issued several times more of such receipts (notes) than the metal deposited with them. Crowther observes that

"the present-day banker has three ancestors: Merchant, Money lender and Goldsmith. A modern bank is something of each of these. It is said that money has two properties. It is flat so that it can be piled up, and it is round so that it can circulate. The progeny of the Money lender are concerned with flat money, piled up money, savings. The progeny of the Goldsmith are concerned with round money, circulating money, cash".  

Gradually the banking business passed from individuals to joint stock concerns. It was a long time before the state realised the danger of allowing every bank to issue notes. Gradually the note-issue function was taken over from the ordinary banks and was entrusted under strict regulations, to the Central Banks.

\[\text{"Quoted in Ibid.}\]
The banks in the meantime discovered new methods of creating purchasing power. They allowed their clients to issue cheque against the deposits outstanding to their credit. These deposits were not necessarily the money actually 'deposited' by the clients. They could be created by the bank allowing what are known as 'overdraft facilities' or by advancing loans against securities. As long as the bank was sure of a safe proportion of cash reserves, it could raise a high superstructure of credit by advancing loans or giving overdraft facilities.  

BANKS IN CAPITALIST SYSTEM

Banks, special economic institutions that accumulate money and savings, grant credit, handle monetary payments, put certain types of money in circulation, issue securities and deal in them, and perform other functions. Banks arise in society on the basis of commodity monetary relations. The socio-economic role of banks is determined by the specific nature of the corresponding Social systems.

The extraction of profit is the basic goal of their activity. In many instances, they have income joint stock companies, a change which has sharply expanded the possibilities of their growth.

In a capitalist economy, there is a complex banking system at work, as well as belated types of financial credit institutions such as

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7 Ibid., p. 395
insurance investment and financial companies, savings and construction funds and pension funds. In their aggregate, they form the credit system. In terms of their functions and character, the banks themselves can be divided into the following types: Central issue banks, Commercial (deposit) banks, investment bank, saving banks, and special purpose banks (mortgage, agricultural, foreign trade, and so forth). In terms of ownership banks can be divided into joint-stock banks, banking houses (non-joint stock), co-operation banks (in the United States, mutual banks), municipal and commercial banks, State Banks, mixed banks with state participation and inter-governmental banks.  

**BANKS IN SOCIALIST SYSTEM**

Under socialism, banks differ fundamentally from Capitalist banks, and have a decisive advantage over them. The banks of the socialist nations service monetary circulation and credit relationships in the socialist economy, as well as providing accounting and control over the economic financial activities of the state and co-operative enterprises. Credit investments of the banks have a productive and socially useful character. They are used for developing the economy and for revising the standard of living of the people. All funds accumulated by the banks go to develop production, as well as into the sphere of distribution and circulation. The dictatorship of the proletariat uses

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banks turning them into one of the powerful levers for building Socialism.⁹

Upon the introduction communism in the USSR and Eastern Europe, all credit institutions were nationalized. Central and Commercial banking functions were concentrated in one huge institution, the State Bank, other credit functions having to do with the financing of agriculture, with investment operations, with foreign trade, and with the promotion of savings usually were delegated to specialised institutions.¹⁰

The bank was the key of the Socialist nations service monetary circulation and credit relationships in the socialist economy, as well as providing accounting and control over the economic-financial activities of the state and co-operative enterprises Lenin attached special significance to the banking system to ensure successful ‘transition from the capitalist mode of production to the mode of production of associated labour’.¹¹ Without big banks, socialism would be impossible, Lenin wrote;

"The big banks are the 'state apparatus' which we need to bring about socialism and which we take ready-made from capitalism, our task here is merely to lop off what capitalistically mutilates this excellent apparatus, to make it

even bigger, even more democratic, even more comprehensive... A single State Bank, the biggest of the big, with branches in every rural district, in every factory, will constitute as much as nine-tenth of the socialists apparatus. This will be country-wide book-keeping, country-wide accounting of the production and distribution of goods, this will be, so to speak, something in the nature of the skeleton of socialist society.  

Lenin's principles for organizing money circulation, credit and the structure of banking are the following ways:  

- Elimination of superfluous line in the banking system, and its rationalization and reorganisation on functional principal.
- Transition from use of commercial credit to direct bank financing of enterprises and organisations.
- Concentration in the national Central Bank of the functions of short-term lending, settlement, issue, and collection serving of the process of socialist reproduction.

• Issue of money and its securing by the country’s whole wealth in accordance with the real needs of production and circulation.

• Organisation of current and long term planning of money circulation and credit.

• Establishment of economic control over the production, commercial, and financial activity of enterprises and organisations through the settlements, loan and collection operations of banks.

• The introduction of a foreign exchange monopoly as a fundamental principle of the organisation of international monetary relations of the socialist community.

• Centralization of banking as a monopoly in the hands of the state.

• Subordination of all banking activity to the economic plans.

• Specialization according to functions.

• Utilization of banks as central book-keeping units and as instruments of control and verification of planned transactions. The banking system consists of a Central Bank, called the State Bank (Gosbank), an Investment Bank (Stroibank), and savings institutions.
The use of banks as levers of socialist transformation in a society is possible only through socializing production by the dictatorship of the proletariat and by creating socialist production relatives. The process of establishing a new economic system includes not only economic system and socialist socialization of production but also the creation of socialist system for the distribution and exchange of social product. This system would include, in particular, the banks and the apparatus of accounting and distribution. The programmatic positions of Marx and Engles concerning the use of banks by the Socialist state were developed creatively by V.I. Lenin in consideration of the new historical conditions and on the basis of the practices of the Great October Socialist Revolution.

Lenin’s plan for the Socialist transformation of the banks included, in addition to nationalizing the capitalist banks, the following basic elements: unification of the nationalized banks into a single nationwide State Bank, an increase in the network of its affiliates and their spread across the entire nation. The democratisisation of banking affairs, the concentration of all monetary circulation in the nation of hands of the State Bank, and the development of clearing transactions through the banks, Lenin pointed out that only a state monopoly of banking made it possible for the Socialist state to direct and control the work of the banks in accordance with the tasks of planned economic development and a steady growth in the prosperity of the people. With
the banking monopoly, it was possible to use the banks as a means for controlling the courses of fulfilment of the national economic plan as well as for strengthening the alliance between the working class and the peasantry. Without large banks as part of the Socialist state apparatus, Socialism would be unfeasible.\textsuperscript{14}

The dictatorship of the proletariat uses banks, turning them into one of the powerful levers for building socialism. Under Socialism, the income from banking operation was used for the needs of the national economy and the population. Banks were not subject to monetary credit crises. Since the Socialist economic system excludes the possibility of their occurrence. The volume of credit, payment and cash operation of the banks grows in accordance with the continuous growth of production and circulation, contributing the rapid rate of expanded Socialist reproduction.\textsuperscript{15}

Because banks are a means for the redistribution of money, they in a planned way organize and concentrate the state funds for crediting the national economy, provide the credit, special and repayable (short-term and long term) crediting of the economy, grant loans to the population for consumer needs, and provide free financing of capital construction using the state budget and special-purpose funds. Through banks, the

\textsuperscript{14} Great Soviet Encyclopedia, vol.2, n.8, p-626.
\textsuperscript{15} Ibid.
Socialist community provide credit help to the developing nations that have thrown out the yoke of colonialism. In fulfilling the function of the clearing centres of the Socialist economy, the banks organize and carry out clearing operations between enterprises for material commodities and services and also handles the payments of enterprises of the financial and banking system. Banks handle payments arising out of foreign trade and other economic interrelationships with foreign states.

The single-issue bank of the USSR was State Banks i.e., Gosbank provided the emission and cash services for the socialist economy and the population as well as the planned day-by-day regulation of monetary circulation. The bank centralizes, holds and uses foreign exchange funds. Soviet currency consists of bank notes issued by the State Bank. The currency issued by the State Bank was on behalf of the treasury consisting of minor coins.¹⁶

Since all the monetary circulation of the national economy passes through the banks, they fulfil the role of a statewide system of accounting and book-keeping for the Socialist economy. In keeping the accounts of the enterprises and organisation and in providing their payment and cash services, the banks help to safeguard the money in the national economy.

¹⁶ The bank notes, called Kupiury, are issued in denominations of 10, 25, 50, and 100 Rubles. The currency is issued in 1, 3, and 5 Ruble denominations, the coins, represent various numbers of kopecks (100 kopecks = 1 ruble)
In the Socialist economy, banks help to strengthen the economic alliance between the working class and the peasantry and between the state and cooperative sectors of socialist production.\(^{17}\) Banks provide help to the kolkhozes in compiling their production and financial plans, in organizing accounting and reporting, and in systematizing their financial system.

Banks contributed to a further strengthening of economic collaboration and mutual aid between the Socialist nations by providing credit, payment, and foreign exchange services for the foreign trade and other relations between these nations.

The Soviet banking system plays an integral role in the planning process. Soviet banking is quite unlike its western counterpart, for it is dominated by a single bank, Gosbank (The State Bank), which was a monopoly bank in its pursuit form. As a monopoly bank, Gosbank combines the functions of Central and Commercial banking but owing to the absence of money and capital markets, some traditional banking functions (open market operations, commercial paper transactions, etc) are not performed by Gosbank.\(^{18}\)

Banks perform a large variety of functions in the modern society. The terms 'bank' and 'banker' derive from the Italian word banco means 'table'. The moneychangers and users carried out their transactions from behind the table.\(^{19}\) Bank has been defined in numerous ways according to the aspect or aspects. However, in essence Banks deal with money.\(^{20}\) Banks play a key role in converting the savings of households and other sectors of the economy into productive types of investment.\(^{21}\)

Bank also receives deposits from those who want it to be kept safely and also earn some interest. In other words, it borrows money. It also lends money to the needy. The borrowing and the lending of money are its essential functions. It may therefore be defined as an institution which borrows and lends money. The purchase and sale of the use of money are Credit operations that are why economists usually define banks as institutions dealing in credit and money.

Banks widely differ in respect of their ownership, sources of finance, objectives, methods and scope of operations etc. In that way some are concerned with regional and other with national.\(^{22}\) Today Banks

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are powerful economic force, that is why Banks are always closer to the economy.  

Banks also widely differ in respect of their ownership. Sources of ‘Banking institutions and organisations’ are a term that is quite widely used in both the serious scientific as well as educational literature.  

Banks perform a number of functions, which can be conveniently divided into three classes: - 

**Primary functions**  
**General utility functions and**  
**Agency functions**  

**PRIMARY FUNCTIONS**

The primary and essential functions of a bank are in two ways: the borrowing and the lending of money. This essential feature of its business remains the same whether the bank is a vast joint stock organisation with a wealth of resources and network of branches and agencies, or a comparatively small private bank.  

Banks perform the primary functions in the following ways:-

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23Medvedkev, n.20, pp.94-95.  
24Lavrushin,n.4, pp.94-95.  
Banks borrow money in the shape of deposits. Persons having money but faced with the problem of its proper investment or safe custody, deposit it with banks and in many cases, they receive interest. Money may be deposited in a Current Account or a Fixed Deposit Account or a Saving Bank Account. In the case of a Current Account, the deposited money may be withdrawn by cheques whenever necessary and without giving any notice to the bank. Usually no interest is given on current deposits, unless a minimum balance of a considerable sum is maintained. In the case of Fixed Deposit Account, the deposit is made for fixed period of time and is not withdrawable before the expiry of that period. In the case of a Saving Bank Account, money deposited may be withdrawn with certain limitations, such deposits carry a moderate rate of interest. This function of the bank encourages people to save money. When it is known that an easy and convenient means of safe and profitable investment of money in the shape of deposits is available. People begin to take pleasure in seeing the balance of their Bank account (Pass Book) increase in amount through deposits and interest.

The small deposits received by banks together constitute a huge amount. This is lent out by the banks to capable agriculturists, industrialists and businessmen who invest it in their ventures of their own profit and to

the economic advancement of the country. Money is lent to industrialists, agriculturists and traders in various ways. The discounting of bills of exchange and the granting of overdrafts on current accounts are two important methods of commercial credit.

GENERAL UTILITY FUNCTIONS

Besides the primary functions mentioned above the modern bank perform many miscellaneous functions, which are of great general utility: -

- Issue of notes

The issue of notes is usually entrusted to a duly constituted Central or Reserve Bank of the country which has the capacity to perform this service more efficiently than the Government. In India the sole right of the note issue is vested in the Reserve Bank of India. In Great Britain, the Bank of England has the responsibility. In Soviet Union Gosbank (State Bank) and after disintegration, Central Bank of Russia has this right.

27 Ibid., p. 203.
• **Supply of Currency**

Modern banks are not only supplying paper currency but all forms of currency are put into circulation. They also discharge the relative duty of withdrawing from circulation of coins and notes.

• **Issue of Credit Instruments**

Banks create credit instruments like bank drafts, cheques, letters of credit, etc, which economise the use of metallic currency and make the transmission of money over long distance convenient and cheap.

• **Foreign Exchange Business**

In olden days, each country used to have different kinds of money in different parts and bankers did the useful work of changing one kind of money into the other kind. This gave them the name of “money changers”. This function has now become defunct, as each country has begun to maintain a uniform currency. But different countries still possess different currencies and banks play the important role of purchasing and selling foreign currency, foreign bills of exchange and other credit instruments in exchange for the currency of the country in which they are situated.²⁸

²⁸ Ibid.
- **Safe custody of valuables**

  Banks undertake to keep in safe custody valuables and important documents in specially constructed strong rooms, which are sure safeguards against fire and theft.

**AGENCY FUNCTIONS**

Banks also render many ‘agency services, by acting as agents of their customers in various capacities: -

- Collection and payment of cheques, bills and promissory notes.\(^{29}\)

- Banks conduct stock and share transactions on behalf of their customers

**KINDS OF BANKS**

The financial requirements of the modern community are diverse and various so that different types of banks have been set up for specialising in different kinds\(^ {30} \) of works as mentioned below: -

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\(^{30}\) Dewett.n.3.p.395.
• **Commercial Banks**

These are chiefly engaged in financing internal trade and carry on other ordinary banking business of receiving deposits, advancing loans and of discounting bills.

- **Exchange Bank**

The main function of such banks is to buy and sell foreign currencies, rather titles to foreign currencies, in the form of bills of exchange, drafts, telegraphic transfers, etc.

- **Industrial Bank**

These institutions specialise in the financing of industry. They advance loans for long periods to people who carry on industrial enterprises.

- **Agriculture Banks**

Such banks provide long and short period finance in the field of agricultures. Long-period capital is required for acquisition and improvement of land and purchase of heavy equipment. Short period capital is necessary for current expenditure on seed, manures, wages, etc.

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31 Ibid.
In India such banks take the form of co-operative societies for short-period lending and land mortgage banks for long-period loans.

- **Co-operative Banks**

  They are usually started with the object of financially short-term needs of agriculture and industries.

- **Saving Banks**

  These institutions provide facilities to people, usually of small means, to save money. Post Offices in India carry on this function. Of course other banks also accept savings deposits.

- **Indigenous or Private Banks**

  In most of the countries there are a large number of private or individual bankers who have been catering to the various types of financial requirements (long term, short-term, etc) of the community as a hereditary occupation.

- **Central or Reserve Bank**

  It does not deal with the general public but its customers are the Government and banks. It acts as a banker to the Government and receives their deposits, pays their cheques and handles their loan and

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32 Agarwala, n.25, p.204.
other operations. It also keeps deposits of other banks and lends them money when they are in need. It also issues bank notes and controls currency and credit.

Among all the banks the Commercial Bank and Central Bank are the principles type of banking in modern era.

FUNCTIONS OF COMMERCIAL BANKS

With the progress of civilization banking is assuming wider functions and greater responsibilities in the economic area, hence it is not possible to make an exhaustive catalogue of its functions and services.

Receiving Deposits from the Public

The most important function of commercial banks is to accept deposits from the public. Banks maintain demand deposit accounts for their customers and convert deposit money into cash and vice versa, at the discretion of the latter. Demand deposits are technically accepted on Current Accounts, which are withdrawable any time by the depositor by means of cheques. Deposits are also made on Fixed Deposit Accounts, which are withdrawable only after a specified period. Fixed deposits are time liabilities of the banks. Deposits are also received in Savings Bank Accounts subject to certain restrictions on the amount so receivable and
withdrawable. This is how the banks pool the scattered savings of the community and serves, so to say, as the reservoir of its savings.33

Money creation

Money creation (and destruction), the most distinctive function of commercial banks, derives from the fact that demand deposits serve as money in the community. The mainstay of commercial banking is the buying and selling of evidence of debts or earning assets; in the process the banks create and destroy money. When commercial banks acquire earning assets or debt instruments, they credit the demand deposit accounts of those selling or transferring these assets to them. And when banks reduce their holdings of such assets (i.e. sell them) demand deposits are obviously, decreased to that extent. Thus, commercial banks create and destroy the community's money supply through variations in their earning assets or debt instruments being the most important direct sources of changes in the money stock (in the form of demand deposits-regarded as money). Hence, banks are generally responsible for most of the fluctuations in the money supply in a country.34

34 Ibid., p-229.
Making loans and advances

The other major function of commercial banks is to make loans and advances, out of the money which comes to them by way of deposits, to businessmen and entrepreneurs against approved securities. Thus, commercial banks are also a major element in the credit market.

Usually, banks make advances through:-

- Money at call- i.e. loans given for very short periods and generally backed by some collateral security. Such loans are called Call loans.

- Over-draft facilities- i.e. allowing the customer borrower to overdraw his current account, up to an agreed limit, against some negotiable security.

- Discounting bills of exchange- The banks facilitate trade and commerce by discounting bills of exchange. (Which is a written promise by a debtor to the creditor to pay a sum of money usually after 3 months). Discounting a bill of exchange, in fact, means advancing a loan against a promise of repayment in future. It is the most popular methods of lending by the commercial banks because such loans are self-liquiditary in character.
• Direct loans.- Loans (short-term or long-term) may be advanced against some collateral securities by the banks to traders and producers.

Thus, banks act as intermediaries between the savers and borrowers as they are both borrowers and lenders of money. They mobilise the dormant capital of the country and provide capital for productive purposes. They influence not only the size of the money stock, but also the allocation of funds and thus the direction and use of resources in the economic system as a whole. Hence, by their lending and investing activities commercial banks play a crucial role in determining aggregate economic activities of a country.

Use of cheque system

Commercial banks render important services by providing an inexpensive medium of exchange like cheques. In modern business transactions, the use of cheques to settle debts is found much more convenient than the use of cash. In fact, the cheque is also known as the most developed credit instrument.

In addition to these, commercial banks perform a multitude of other functions which may be classified as:

Agency services, and

General utility services.
- **Agency Services**:- Bankers perform certain functions for and on behalf of their customers such as:-

- Collection and payment of promissory notes, cheques, bills and other commercial instruments, interest, dividends, subscriptions, rents or other periodical receipts and payments like insurance premium. For these some charges are usually levied by the banks.\(^{35}\)

- Buying and selling of shares, bonds, securities, etc, on behalf of their clients.

- Remittance of funds on behalf of customers by drafts or mail or telegraphic transfers.

- Acting as executors, trustees and attorneys for their customers. Sometimes bankers also employ income-tax experts to prepare the income-tax returns of their customers and to help them to get refund of income-tax in appropriate cases.

- Acting as correspondents, agents or representatives of their clients. Many times, bankers obtain passports, traveller’s tickets, secure passages for their customers, receive on their behalf letters and so on.

\(^{35}\) Ibid., p.230.
All these functions are described as agency services because the banks act in all these cases as agents of their customers.

- **General Utility Services:**

  Modern commercial banks usually perform certain general utility services for society, such as:

  - Issuing of letters of credit to their customers to enable them to go abroad.
  
  - Issuing of bank-drafts and traveller's cheques in order to provide facilities for transfer of funds from one part of the country to another.
  
  - Dealing in foreign exchange, and financing foreign trade by accepting or collecting foreign bills of exchange.
  
  - Serving as referee to the financing standing, business reputation and respectability of customers. They may also work as guarantors of their clients.
  
  - Underwriting loans to be raised by the government, public bodies and corporations.
  
  - Providing safety vaults, so that customers may entrust their securities and valuables to them for safe custody.
• Acting as a trustee and executing the wills of the deceased.

• Compiling statistics and business information relating to trade, commerce and industry. Some banks may publish valuable journals or bulletins containing research on financial, economic and commercial matters.

Thus, commercial banks render invaluable services to a community. Bankers are regarded as 'public conservators of commercial virtues'. A country with a properly developed banking organisation has a secure foundation of industrial and economic progress. It constitutes the very life-blood of an advanced economic society.

FUNCTION OF A CENTRAL BANK

In every country, there is an apex bank (Central Bank) which occupies a very special position in the banking system of that country. The powers and the range of functions of Central Banks vary from country to country. The functions which Central Banks are called upon to perform, the policies they have to pursue and the techniques they have to adopt differ according to the nature of economic conditions in the country in which they are situated. However, there are certain functions.

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16 Agarwala, n.25, p.205.
which are commonly performed by the Central Banks. De Kock mentions the following seven such common functions of Central Banking:

- A Central Bank regulates currency by enjoying the sole or partial monopoly of note issue, i.e. it acts as a Bank of Issue.

- It acts as a banker and agent to the government.

- It maintains the cash reserves of commercial banks, i.e. it acts as a banker's bank.

- It maintains and manages the foreign exchange reserves of the country, i.e. it acts as the custodian of the nations' reserves of international currency.

- It acts as lender of last resort by accommodating commercial banks.

- It acts as a bank of central clearance, settlement and transfer.

- It acts as controller of credit in order to maintain the monetary standard adopted by the State.

- A modern Central Bank usually also serves as a development agency and promotes the economic development of the country.

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37 quoted in Mithani, n.33, p-262.
Central Bank as a Bank of Issue

Today the Central Bank in every country enjoys the exclusive privilege of bank-note issue. No commercial bank can issue its own currency notes. In fact, as De Kock puts, the privilege of note-issue was almost everywhere associated with the origin and development of Central Banks.

Thus, the Central Banks enjoy the sole of residuary monopoly of note issue. According to De Kock, the main reasons for the concentration of the right of note issue in the Central Banks are as follows:

- It leads to uniformity in the note circulation and its better regulation;

- It gives distinctive prestige to the note issue;

- It enables the state to exercise supervision over the irregularities and malpractices committed by the Central Bank in the issue of notes; and

- It gives the Central Bank some measure of control over the undue credit expansion by the commercial banks, since the expansion of credit obviously leads to an increased demand for note currency.

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38 Agrwala, n.25, p.206.
39 De Kock, Central Banking, p-26, Quoted in Mithani, n.33, p.262.
Moreover, the separation of note-issue from the hands of the state has been advocated mainly because of the danger of over-issue.

As Kish and Elkin put it

"if the government itself has the right of note-issue, political considerations and pecuniary needs of the state rather than considerations of a sound monetary economy are likely sooner or later to become the determining factors." 40

The Central Bank keeps three considerations in view in its issue of notes, viz, uniformity, elasticity and security. The right of note-issue is regulated by law. According to the rule, every note issued must be covered by an asset of equal value (assets like government securities, gold, and foreign currencies and securities). This is necessary to inspire public confidence in paper currency.

Central Bank as a Banker to The Government

The Central Bank acts as a banker, agent and adviser to the government. As the government's banker the Central Bank keeps the banking accounts of government departments, boards and enterprises and performs the same functions as the commercial bank ordinarily performs for its customers. It accepts their deposits, undertakes the collection of the cheques and drafts drawn on other banks; it supplies them with the

40 Quoted in Ibid.
cash required for salaries and wages and other cash disbursements and transfer funds for the government from one account to another or from one place to another, etc. Moreover, it also advances short-term loans to the government in anticipation of the collection of taxes or the raising of loans from the public. It also makes extraordinary advances during depression, war or other national emergencies. In addition, the Central Bank renders a very useful banking service to the government by providing by latter with the foreign exchange required to meet the external debt service or for the purchase of goods and other disbursements abroad, and by buying any surplus foreign exchange which may accrue to the government from foreign loans or from other sources.

De Kock rightly views that the Central Bank operates as the government's bankers because of its intimate connection between public finance and monetary affairs. The financial activities of the government exercise a disturbing influence of the money market conditions. Thus, the centralization of government banking and financial operations in the Central Bank enables the latter to judge the general financial situation in a better way and to take appropriate remedial measures.41

As an agent of the government, the Central Bank is often entrusted with the management of the public debt and the issue of new loans and

41 Ibid.
treasury bills on behalf of the government. Also the Central Bank is the fiscal agent to the government and receives taxes and other payments on government accounts.

By acting as a financial adviser to the government, the Central Bank discharges another important service. It gives advice to the government on important matters of economic policy, like deficit financing in a planning programme, devaluation of the currency, trade policy, foreign exchange policy, etc.

Moreover, the Central Bank also works as the representative of the state in international financial matters. The Central Bank has been entrusted with the task of maintaining the nation's reserves of international currency. It is the duty of the Central Bank to maintain the stability of the foreign exchange rate. Being the custodian of the foreign exchange reserves the Central Bank also manages the country's relations with international financial institutions.

Central Bank as a Banker's Bank

Broadly speaking, the Central Bank acts as a banker’s bank in three capacities:

- As the custodian of the cash reserve of the commercial banks;

- As the lender of last resort; and
• As a bank of central clearance, settlement and transfer.

Thus, the Central Bank acts as the conductor and leader of the banking system of a country. It acts as the friend, philosopher and guide of commercial banks. Crowther, therefore remarks: "The Central Bank stands to the member banks in exactly the same relation as the member banks themselves to the public".  

• Custodian of the cash reserves of commercial banks:

As De Kock points out, the Central Bank has become the custodian of the commercial bank's cash reserves by a process of evolution which was closely associated with its functions as bank of issue and banker to the government. Commercial banks found it convenient to keep their cash reserve requirements with the Central Bank because its notes commanded the greatest confidence and prestige and government's banking transactions were conducted by this institution. Thus in every country, commercial banks keep a certain percentage of their cash reserves with the Central Bank by custom or by law.

In fact, the establishment of Central Banks makes it possible for the banking system to secure the advantage of centralised cash reserves. The significance of centralised cash reserves lies in the following facts:

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• The centralisation of cash reserves in the Central Bank is a source of great strength to the banking system of the country as it strengthens the confidence of the public.

• Centralised cash reserves can form the basis of a much longer and more elastic credit structure than the same amount scattered among the individual commercial banks. Obviously, when bank reserves are pooled in one institution, they can be used to the fullest extent possible and in the most effective manner during periods of seasonal strain and financial stringencies and crisis. In short, when cash reserves are centralised in the hands of the Central Bank, it can be mobilised and utilised more efficiently and effectively for the benefit of the banking system as a whole.

• The centralised cash reserves enable the Central Bank to provide additional funds to those banks which are in temporary difficulties. In fact, the Central Bank can function as a lender of last resort on the basis of the centralised cash reserve with it.

• The centralisation of cash reserves is conducive to the economy and to increased elasticity and liquidity of the banking system in particular and of the credit structure as a whole. In the absence of centralised cash reserves of a Central Bank, each commercial bank will have to keep sufficient reserves for all types of emergency. Similarly, without a centralised cash reserve and rediscounting
facilities of the Central Bank on its base, commercial banks cannot have sufficient liquidity without a large fund. Thus, economy, elasticity and liquidity of commercial banks are promoted by the Central Bank as a bankers’ bank.

- The centralisation of cash reserves also enables the Central Bank to influence and control the credit creation of commercial banks by increasing or decreasing the cash reserves of the latter, i.e. through the technique of the variable reserve ratio.

**Lender of the last resort**

As a lender of the last resort, in times of emergencies, the Central Bank gives financial accommodation to commercial banks by rediscounting their eligible bills. The monopoly of note-issue and the centralisation of cash reserves with the Central Bank increases its capacity of granting credit, and thus to rediscount and act as lender to last resort. The Central Bank is the ultimate source of money under the modern credit system. The function of lender of last resort implies that the Central Bank assumes the responsibility to meet directly or indirectly all reasonable demands for accommodation from commercial banks. The Central Bank’s function of lender of last resort developed out of the rediscount function during emergency period. The function of rediscount

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43 Agarwal, n.25, p.205.
is generally regarded as an essential function of a Central Bank, and it is largely due to this that a Central Bank is frequently described as a bankers’ bank.

The real significance of rediscount, according to De kock, lies in the fact that it increases the elasticity and liquidity of the entire credit structure. By affording a ready medium for the conversion into cash of certain assets of the banks, it helps to maintain their liquidity. It also makes possible a considerable degree of economy in the use of cash reserves, since the commercial banks can conduct a large volume of business with the same reserve and capital. Hawtrey puts it thus:

“The essential duty of the Central Bank as the lender of last resort is to make good a shortage of cash among the competitive banks”.44

Bank of Central Clearance, settlement and Transfer:

The Central Bank acts as a clearing house for member cash reserves of commercial banks, it is an easy and a logical step for it to act as a settlement bank or a clearing house for the Central Bank to set up an expeditious and economical machinery for the clearance of drafts and settlement of internal accounts, and that ‘as holder of the balances of the commercial banks a Central Bank is specially qualified for this duty.’

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44 Mithani, n.33, p.267.
As all banks have their accounts with the Central Bank, the claims of banks against one another are settled by simple transfers from and to their account.

This method of settling accounts through the Central Bank apart from being convenient is economical, as regards the use of cash. Since claims are adjusted in accounts, there is usually no need of money. It also strengthens the banking system by reducing withdrawals of cash in time of crisis. Furthermore, it keeps the Central Bank informed about the state of liquidity being maintained by the commercial banks with regard to their assets. As a controller of credit, it is necessary for the Central Bank to know this.

The controller of credit

It is an important function of a Central Bank that it should adopt and enforce a proper monetary policy which may serve the best interests of the country.\textsuperscript{45} By far the most important of all functions of the Central Bank in modern times is that of controlling credit operations of commercial banks. De Kock observes:

"It is the function which embraces the most important questions of Central Banking policy and the one through which practically all the other functions are united and made to serve a common purpose."\textsuperscript{46}

\textsuperscript{45} Agarwala, n.25, p. 206.
\textsuperscript{46} Mithani, n.33, p.267.
In a modern economy, credit plays a predominant part in the settlement of monetary and business transactions of all kinds. Thus, fluctuations in the volume of credit by causing wide fluctuations in the purchasing power of money and in-price levels cause social and economic upheavals of high magnitude. It is therefore universally agreed that credit should be subject to control. The Central Bank being an apex monetary institution or financial authority, the task of credit control is assigned to it.

Under the gold standard, the control of credit was considered necessary just to maintain the foreign exchange rate stable irrespective of whether it resulted in inflation or deflation. But today the object of controlling credit is to eliminate business cycles, and maintain a high level of economic activities and employment and at the same time achieve the objective of international exchange stability. Since cash is the chief basis of creating credit, a Central Bank as a bank of issue and custodian of cash reserves can control credit by varying the amount of common money with the public and thereby the amounts of deposits with the banks and their cash reserves and influence their credit-creating activities.

For controlling credit, a Central Bank may use various tools such as bank rate, open market operations, changes in reserve ratios, selective methods of credit control, etc. In order to make its monetary policy
effective, the Central Bank and the government must co-operate and consult each other so that the conflict between fiscal policy and monetary policy is avoided.

**Central Bank as the Promoter of Economic Development**

The modern Central Bank performs a variety of developmental and promotional functions which in the past were regarded as being outside the normal purview of Central Banking. Today, the Central Bank is regarded as an inevitable agency for promoting the economic growth of a country. It is an institution responsible for the maintenance of economic stability and for assisting the growth of the economic development of the country. It has the responsibility of the development of an adequate and sound banking system for catering to the needs not only of trade and commerce but also of agriculture and industry. The Central Bank has to ensure, in the interest of economic progress, that the commercial banks operating in the country are being conducted on reasonably sound and prudent basis. Thus, the major task of the Central Bank may be regarded as the development of highly organised money and capital markets that may help to accelerate economic progress by assisting quick and huge investment activities in capital formation and other productive channels. During the planning era, the Central Bank’s

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17 Ibid., p.269.
role as adviser to government on economic matters in general and on financial matters in particular is of considerable importance.

Thus, the Central Bank of developing country has important roles to play in the process of development. In underdeveloped countries, the Central bank has not only to provide adequate funds and control inflation through credit regulation, but it has also to under take the responsibility of spreading banking facilities providing credit at cheap rate to agriculture and industry, protecting the market for government securities and channelling credit into desirable avenues. Moreover, in underdeveloped countries there are institutional gaps in the money and capital markets which hinder economic growth. The banking system is not properly organised. A large section of the money market consists of unorganised, indigenous bankers. Thus, promotion of sound, organised, well-integrated institutions and agencies of money and capital markets becomes the important function of a Central Bank in a developing economy. From the development point of view, in an underdeveloped country deficiency or non-existence of institutions like savings banks, agricultural credit agencies, insurance companies and the like to collect and mobilise savings and make them available for productive investments, is the main cause of the low rate of capital formation.

Hence, the growth of such institutions in these countries is the pre-

\[48\] Ibid.
condition for capital formation which is the master-key to economic development. Evidently, therefore, the Central Bank of a developing country has vital role to play in building up the financial infra-structure of future economic development.

Edward Nevin, thus, stresses that the usefulness of a Central Bank in a developing economy must be assessed primarily in terms of its ability to assist the process of economic growth and capital formation; the contribution it can make to the regulation, direction and guidance of such credit institutions as exist at the time must be of secondary and lesser consideration.49

For the modern Central Bank, whether in a developed or a developing economy, thus, the development aspect of central banking policy is of greater importance than its regulatory aspect. The promotional or developmental aspect of Central Banking policy includes all such functions and activities that are inevitable for economic growth.

In addition to the above stated functions a Central Bank may also undertake miscellaneous functions such as providing assistance to farmers through cooperative societies by subscribing to their share capital, promoting finance corporations with a view to providing loans to

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the large scale and small-scale industries, publishing statistical reports on trends in the money and capital markets, etc.

In fine, a Central Bank is an institution which always works for the best economic interest of the nation as a whole.

CONCLUSION

Banks are an integral part of the modern money economy. Their activity is closely connected with the needs of reproduction. They are at the centre of economic life and serve the interest of producers, they act as intermediaries in relations between industry, trade, agriculture and population.

Banks perform a large variety of function in modern society. The borrowing and the lending of money are its essential functions. It may therefore be defined as an institution which borrows and lends money. Banks also issue notes which is duly entrusted to Central Bank. Central Banks are principal type of banking in modern era.

In the Socialist economy, banks help to strengthen the economic alliance between the working class and the peasantry and between the state and cooperative sectors of socialist production. In capitalist countries saving are used to finance the business of small, middle and bourgeoisie.

The soviet banking system plays an integral role in the planning process.