



CB — Central Banking

Complete Book | Table of Contents | 18 chapters + 8 sections

Module A — Rationale and Functions of Central Bank

CH-1	Theory and Practice of Central Banking- Evolution	2
CH-2	Functions of Central Banks	4
CH-3	Contemporary Issues in Central Banking	9

Module B — Central Banking in India

CH-4	Reserve Bank of India	12
CH-5	Central Banking - Indian Specific Issues	18
CH-6	Financial Inclusion and Development	23

Module C — Monetary Policy and Credit Policy

CH-7	Monetary Policy	26
CH-8	Credit Policy	30
CH-9	Fiscal-Monetary Relations	33
CH-10	Liquidity Management	36

Module D — Management of Foreign Exchange Reserves and Constituents of Indian Financial Market

CH-11	Management of Foreign Exchange Reserves	40
CH-12	Constituents of Indian Financial System Structure	43

Module E — Regulation, Supervision and Financial Stability

CH-13	Evolution of Regulation and Supervision	47
CH-14	Development, Regulation and Supervision and Recent Performance of Scheduled Commercial Banks	50
CH-15	Development, Regulation and Supervision of Co-Operative Banks	56
CH-16	Financial Stability	60

Module F — Non-Banking Financial Companies and Primary Dealers

CH-17	Non-Banking Financial Institutions - Development, Regulation and Supervision	66
CH-18	Role of Primary Dealers in the Government Securities Market - Evolution and Development, Regulation and Supervision	70

Additional Resources

—	Appendix - Central Banking	74
—	Case Studies — Module A: Rationale and Functions of Central Bank	77
—	Case Studies — Appendix: Supplementary Reference	82
—	Case Studies — Module B: Central Banking in India	83
—	Case Studies — Module C: Monetary Policy and Credit Policy	89
—	Case Studies — Module D: Management of Foreign Exchange Reserves and Constituents of Indian Financial Market	95
—	Case Studies — Module E: Regulation, Supervision and Financial Stability	98
—	Case Studies — Module F: Non-Banking Financial Companies and Primary Dealers	105

CH-1

Theory and Practice of Central Banking- Evolution

Topic 1 — Central Bank and Its Features

A **central bank** is the **apex bank** of a country, responsible for managing the **money supply**, controlling **interest rates** and ensuring the **stability and soundness** of the financial system.

Feature	What it involves
Monetary authority	Manages money supply and interest rates; influences growth and inflation through policy tools
Currency issuance	Issues currency under powers given by national law ; coins and foreign reserves follow national arrangements
Banker to the Government	Keeps government accounts and facilitates its borrowing needs
Banker to banks	Holds bank reserves, provides emergency funding , maintains stability
Financial stability	Ensures smooth functioning of the financial system
Regulatory authority	Enforces regulations and oversees banking operations
Economic analysis	Research, forecasts and advice to government and institutions

Topic 2 — Global Evolution of Central Banks

- **Oldest** — The **Riksbank of Sweden (1668)** is the **oldest central bank**.
- **Origin** — It was set up under Sweden's **Parliament** to provide banking services.
- **Change** — It later gave up commercial lending.
- **Note issue** — It received the **monopoly of note issue in 1904**; the decision was taken in **1897**.
- **Spread** — France, Finland, Netherlands, Austria, Norway, Denmark, Portugal, Belgium, Spain, Germany, Italy and Japan set up central banks in the **1800s and early 1900s**.

Stage	Development
Financial infrastructure	Central banks developed the financial system to suit national needs; as they finalise transactions , they came to manage payment and settlement systems
Regulation and supervision	As institutions multiplied, central banks took stronger regulatory and supervisory roles and introduced risk management systems
Developmental mandate	In developing countries, roles widened to economic recovery and growth ; amid global growth and crises, emphasis on price stability, financial stability and risk management
Informal norms to formal laws	Self-imposed codes became formal laws , amended periodically; central banks are urged to adopt international best practices for autonomy, crisis prevention and transparency

Topic 3 — Early Central Banks of Europe

Central bank	Origin	Key features
Bank of England	1694 , Royal Charter; nationalised 1946	Second oldest after Riksbank. It accepted deposits and issued notes. It became government's banker and debt manager and controlled UK gold reserves.
Bank of England (contd.)		It sets official interest rates, with operational independence from 1997 . The Bank Charter Act 1844 restricted new note issuers; full monopoly came in 1921 .
Bank of England (contd.)		It managed government borrowing in World War I. It is adviser and agent of the Treasury.
Bank of France	1800 ; nationalised 1945	Founded with private capital but closely linked to the State. Government appointed the Governor and two Deputy Governors .
Bank of France (contd.)		Shareholders were represented by 15 regents elected by the 200 largest shareholders . Note-issue privilege in Paris ran for 15 years .
Bank of France (contd.)		It was extended to all France in 1848 , when nine provincial banks became its branches. This resolved the 1848 crisis.
Bank of France (contd.)		It gained autonomy under the 1993 law for price stability while remaining state-owned.
Banco de Portugal	1846	Founded as a private institution ; a note-issuing commercial bank whose main job was profit for shareholders
Bundesbank (Germany)	1957 , Bundesbank Law	Rationale: a uniform system of coinage, weights and measures. Created a transparent monetary regime and integrated separate financial entities; now part of the European System of Central Banks (ESCB)
Bank of Italy	1893	Created after the near-collapse of Italian banking in the early 1890s; cleaned up its balance sheet, rebuilt capital and reorganised the monetary and credit system to stabilise the currency; now part of the ESCB

Remember this

- Oldest: **Riksbank 1668**; second oldest: **Bank of England 1694**.

Topic 4 — Federal Reserve System (USA)

- **Meaning** — The **Federal Reserve** is the central banking system of the USA.
- **Set up** — It was set up in **1913** under the **Federal Reserve Act**.
- **Reason** — A series of financial panics, particularly the **panic of 1907**, showed the need for central control of the monetary system.

Aspect	Position
Objectives	Maximum employment, stable prices and moderate long-term interest rates ; the first two form the dual mandate

Aspect	Position
Expanded functions	Supervision, financial system stability and financial services
Components	Board of Governors, FOMC , 12 regional Federal Reserve Banks , privately owned member banks and advisory councils
Board of Governors	7 members , nominated by the President , confirmed by the Senate , for 14-year terms , one term beginning every two years
FOMC	12 voting members : 7 Governors + New York Fed president + 4 other Reserve Bank presidents on rotating one-year terms . All 12 presidents take part in deliberations, but participation does not give a vote
Nature	Both public and private elements, serving the public interest under federal law
Dividends	Smaller member banks get a 6% statutory dividend on paid-in Reserve Bank stock; above an inflation-adjusted asset threshold, the lower of 6% and the 10-year Treasury auction yield
Remittances	After expenses, dividends and required surplus, residual earnings go to the US Treasury . Losses suspend remittances and create a deferred asset , which future earnings must first cover

Topic 5 — Evolution and Diversification of Functions

- **New challenges** — As financial systems developed, central banks reoriented policies to meet new challenges.
- **Crisis mandates** — During crises such as the **Great Depression (1930s)**, mandates covered **monetary stability, full employment and maximisation of growth**.
- Functions fall into four groups: **monetary policy, banker to banks, banker to the government** and **developmental functions**.
- The **lender-of-last-resort** role grew with financial sector development, prompting stronger **supervisory and regulatory** roles.
- Recognising the link between financial and economic development, central banks facilitated finance to **productive sectors**.

Topic 6 — Reasons for Proliferation of Central Banks

Proliferation means the widespread establishment and growth in the number of central banks across the world.

Reason	Explanation
Economic complexity	Larger, complex financial sectors needed a centralised authority for monetary policy and oversight
Bank failures	Failures raised depositor concern, increasing the need for regulation and stability
Rise of nation-states	New nations in the twentieth century set up their own central banks
Specific roles	Currency issue, lender of last resort, government finances, regulation
Global banking	Globalisation needed a central authority to deal with the global financial network and international relations

Topic 7 — Conflicting Roles and Responsibilities

Area	Nature of conflict
Banker to government vs price stability	As debt manager , financing deficits through central bank credit causes excess money creation and inflation , weakening price stability
Independence and inflation targeting	Independence gained ground after the Vietnam War , world liquidity expansion, persistent inflation and fiscal–monetary expansions in Latin America . Inflation targeting became a principal objective, pursued independently
Regulation and supervision	Combining both in one authority raises conflict of interest ; on the lines of Montesquieu's separation of powers , supervision may be separated from the central bank

- **PRA** — The **Prudential Regulation Authority (PRA)**, within the Bank of England, handles prudential supervision.
- **FCA** — The **Financial Conduct Authority (FCA)** handles conduct and relevant prudential regulation.
- **See** — Ch 13 (p. 47) for the UK's move from the FSA to the PRA and FCA (2013) and how supervisory arrangements vary across countries.

Topic 8 — Central Banks in Developed and Developing Countries

Aspect	Developed countries	Developing countries
Emergence	Earlier , evolving with modern economies	Later , after colonisation or political upheaval
Initial focus	Currency issue , later monetary policy, stability and regulation	Stabilising local currency , basic financial infrastructure, economic development
Independence	Push for independence for stable monetary policy	Initially close ties to government ; political interference and limited resources
Innovation	At the forefront of financial innovation	Reforms to align with global standards
Later trend	Modern tools and strategies	Greater autonomy and international best practice to manage inflation, growth and stability

CB | Module A | CH-1 | MCQs

Q1. A country's apex institution manages money supply, holds banks' reserves and keeps government accounts. Which feature is NOT typically a central bank feature? [Ref: Topic 1, p. 2]

- Accepting retail deposits for profit as its primary goal
- Acting as banker to the government
- Acting as banker to banks
- Ensuring financial stability

Q2. The Riksbank's transformation into a modern central bank involved [Ref: Topic 2, p. 2]

- (a) merging with a commercial bank
- (b) becoming part of the ESCB
- (c) giving up commercial lending and getting a monopoly of note issue
- (d) privatisation of its capital

Q3. Under the UK Bank Charter Act 1844, the position on note issue was that [Ref: Topic 3, p. 2]

- (a) the Bank of England immediately got full monopoly
- (b) all commercial banks could freely issue notes
- (c) the Treasury took over note issue
- (d) new issuers of banknotes were restricted, with full monopoly to the Bank of England coming later

Q4. The Bank of France's note-issue privilege was extended to the whole country because [Ref: Topic 3, p. 2]

- (a) the 1993 law granted autonomy
- (b) nine provincial note-issuing banks became its branches
- (c) it was nationalised
- (d) it joined the ESCB

Q5. A student argues that a state-owned central bank cannot be independent. Which example best rebuts this? [Ref: Topic 3, p. 2]

- (a) Banco de Portugal was a private profit-making bank
- (b) Bank of Italy was set up to clean up balance sheets
- (c) France granted monetary-policy independence while retaining state ownership
- (d) Bundesbank was set up for uniform coinage

Q6. The Federal Reserve's 'dual mandate' refers to [Ref: Topic 4, p. 2]

- (a) stable prices and moderate long-term interest rates
- (b) maximum employment and stable prices
- (c) financial stability and supervision
- (d) exchange rate stability and growth

Q7. At a given FOMC meeting, how many Reserve Bank presidents vote? [Ref: Topic 4, p. 2]

- (a) All twelve
- (b) Seven
- (c) Only the New York Fed president
- (d) Five, including the New York Fed president

Q8. A large Fed member bank above the asset threshold receives a dividend on paid-in stock equal to [Ref: Topic 4, p. 2]

- (a) the lower of 6% and the ten-year Treasury auction yield
- (b) a fixed 6%
- (c) the higher of 6% and the Treasury yield
- (d) nothing; all earnings go to the Treasury

Q9. If a Federal Reserve Bank incurs losses, then [Ref: Topic 4, p. 2]

- (a) the Treasury injects capital immediately
- (b) remittances to the Treasury are suspended and a deferred asset is created
- (c) member bank dividends become zero by law
- (d) the FOMC loses its voting rights

Q10. Extending central bank credit to finance government deficits mainly conflicts with [Ref: Topic 7, p. 3]

- (a) the payment system objective
- (b) the developmental function
- (c) the price stability objective
- (d) the currency design function

Q11. Applying Montesquieu's separation of powers to central banking suggests [Ref: Topic 7, p. 3]

- (a) merging fiscal and monetary policy
- (b) abolishing the lender-of-last-resort role
- (c) giving note issue to commercial banks
- (d) separating supervision from the central bank

Q12. In the UK, prudential supervision of banks is now done by [Ref: Topic 7, p. 3]

- (a) the Prudential Regulation Authority
- (b) the Financial Services Authority
- (c) the Financial Conduct Authority alone
- (d) HM Treasury

Q13. Which is a reason for the proliferation of central banks in the twentieth century? [Ref: Topic 6, p. 3]

- (a) Decline of financial complexity
- (b) Emergence of new nation-states
- (c) Fall in bank failures
- (d) Abolition of paper currency

Q14. Compared with developed countries, central banks in developing countries initially [Ref: Topic 8, p. 3]

- (a) led financial innovation
- (b) had full statutory independence
- (c) had closer ties to government and focused on stabilising local currency
- (d) focused only on inflation targeting

Q15. Recognising the link between financial and economic development, central banks [Ref: Topic 5, p. 3]

- (a) stopped acting as lender of last resort
- (b) withdrew from payment systems
- (c) stopped issuing currency
- (d) facilitated finance to productive sectors

Answer key

Q	Ans	Q	Ans	Q	Ans	Q	Ans	Q	Ans
1	a	4	b	7	d	10	c	13	b
2	c	5	c	8	a	11	d	14	c
3	d	6	b	9	b	12	a	15	d

CH-2 Functions of Central Banks

Topic 1 — Banker to the Government

- **Role** — Central banks keep the government's accounts and support its finances.
- **Placing bills** — Historically, governments met direct financing needs by **placing bills** with the central bank.
- **Extent** — The extent of support depended on economic conditions and the central bank–government relationship.

Role	Explanation
Monetisation of government debt	The central bank issues notes against government bills and credits their value to the government's account. This central bank credit to government creates money.
Monetisation of government debt (contd.)	The greater the direct monetary financing , the larger the rise in reserve money and the inflationary pressure . Market borrowing is different.