Karnataka State Open University
Manasagangothri, Mysore - 570 006

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ಮಾನಸಗಂಗೋತ್ರಿ, ಮೈಸೂರು - ೫೭೦ ೦೦೬

COURSE:5 **M.A.(PREVIOUS)**

MONEY-BANKING AND FINANCIAL MARKETS

759

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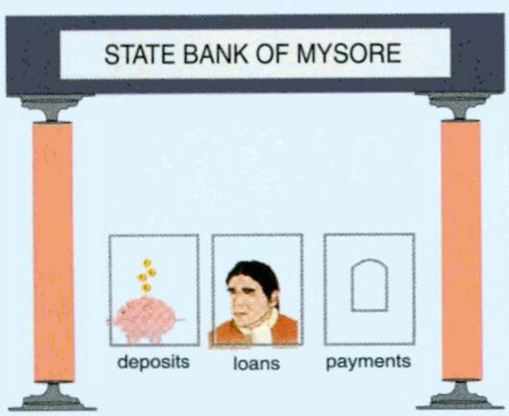

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SHARE MARKET

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Course 5

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6

Introduction

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Vice-Chancellor and Chairperson
Karnataka State Open University
Mysore-570 006

Dean(Academic)-Convenor
Karnataka State Open University
Mysore-570 006

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Reader & Chairperson
DOS in Economics
Karnataka State Open University
Mysore-570 006

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DOS in Economics
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Reader
DOS in Economics
Karnataka State Open University
Mysore-570 006

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BLOCK 6:

BLOCK INTRODUCTION:

This block deals with the British Banking System and American Banking System. This block consits of 7 units. In units 21, 22, 23 and 24 you are going to study British Banking Systems. Unit 21 traces the development of banking and special features of British commercial bank. Unit 22 deals with the evolution of Bank of England and its functions. Unit 23 deals about the structure of commercial banks and unit 24 gives you to details of London Money Market. Unit 25,26 and 27 deals with American Banking System. Unit 25 deals about the development of banking, commercial banking system . Unit 26 helps you in understanding of Federal Reserve System, its organization, functions and finally unit 27 deals about the New York Money Market, and its sub-markets.

UNIT: 21 BRITISH BANKING SYSTEM

Structure

21.1. Objectives

21.2. Introduction

21.3. Evolution of Banking in U.K.

21.4. Special Feature & British Banking

21.5. Let us sum up

21.6. Books for self study

21.7. Questions for self study

21.1 OBJECTIVES

Banking system in U.K. is one of the best system among the countries of the world. After reading this unit, you will be in a position to explain how the present system gradually developed stage by stages. It will help you to under stand how the various banking legislations helped the banking system to be established on a sound footing. It will help you to understand the special feature of banking system in U.K. To-day most of the countries are having their banking system more or less on the same pattern of British Banking System.

21.2 INTRODUCTION

The evolution of British banking stretches over more than 600 years. By the 14^{th} and 15^{th} centuries, advanced financial activities were making an important contribution to Britain's economic development. A brief outline may suggest which of the features of banking as it exists to-day are deep-rooted in the past. This unit will therefore touches only on the main turning-points in the development of banking, in chronological order. The features of banking system which we are going to study in this unit are the features of past and they are found even to-day. In this unit you are going to study first the evolution of banks in U.K. and then its special features or highlights of banking in U.K.

21.3 EVOLUTION OF BANKING IN U.K.

A. The 17^{th} Century

Some rudimentary forms of banking had been practiced in England since the 15^{th} century mainly by Italian houses. But the roots of modern banking started only in 17^{th} century. The first indigenous banking system was established by London goldsmiths. It all started with goldsmith who used to issue paper money on the security of gold deposited with them. These notes were payable on demand and hence enjoyed considerable circulation. By the end of 1685 goldsmith were following many techniques of modern banking namely, they use to lend a portion of this money to people needing finance, issued receipt for money deposited and accepted the written instructions of depositors. Goldsmiths used to deposit their reserves of treasures in the Exchequer under the care of government for the safe custody. The business of the London goldsmiths got a rude shock when charles II shut up the exchequer and refused to return the reserves of treasure to goldsmiths. This marked a turning point in the history of banking which facilitated the growth of private banking.

In 1694 the Bank of England was established with a Royal Charter. The immediate purpose was to raise money for government from rich merchants of London to finance war with France. It was allowed to issue notes, to accept deposits and to discount bills of exchange. In 1697 an act was passed which prohibited establishment of joint stock bank. But it had not forbidden the formation of joint stock companies.

B. The 18th Century

The Act of 1709 prohibited any company or partnership or any body of people exceeding six in number from issuing notes. This clause had far reaching effects and a number joint stock banks we established. Among these Bank of Scotland in 1695 and the Royal Bank of Scotland in 1727 were established. By 1810, over 700 banks were established. But there were several bank failure due to their own faults and 1797 the Bank of England itself was forced to suspend convertibility for several years.

C. The 19th Century

The most severe crisis came in 1825, when about 70 fair sized banks were forced to stop payments. Therefore an Act was passed by parliament in 1825, which allowed joint stock banks to be formed outside a radius of 65 miles from London. But Bank of England which was fighting for its privileges as commercial bank, feared that the joint stock banks would become strong competitors for it. In 1833, however another act of parliament was passed, which permitted joint stock banking throughout the U.K. As a result large banks of to day were established. In 1854 joint stock banks were admitted to the clearing house. Gradually joint stock banks increased their strength and began to absorb the private banks. The extension of the principle of limited liability to banking gave them a further stimules. In 1866 there were 246 private banks and 154 joint stock banks. The joint stock banks began to amalgamate, by 1900 there were 19 private banks and 77 joint stock banks. This process was carried further and the big four banks emerged by 1967-68. In 19th century along with big deposit banks, merchant banks were started, savings banks established, discount market reached the apex of its power, London money market became important international financial centre, Bank of England developed into a modern central bank.

Another important turning point in the history of English banking system was the enactment of the Peel's act of 1844. This act laid down that no new back in the U.K. could issue notes and placed restrictions on existing note issues banks, with clear intention that the bank of England should eventually have a monopoly. This act laid down that the Fiduciary issue should be limited to a fixed amount. All the notes issued in excess of that sum should be backed up by gold. Principle of limited liability was applied to banks 1862 and this encouraged formation of large banks with offices throughout the country.

D. The 20th Century

There were few big changes in the institutional structure or in services of the deposit banks. There was competition for rapid extension of branch net work. In this period deposit banks abandoned the practice of paying interest on current deposit. During this period banks use to keep their advances fairly liquid. Therefore there were no bank failures in the depression years. In this period the British Banker's association and British overseas Bank association were constituted in order to embrace all questions affecting banking. In 1960s banks made a big drive to popularize the banking hobbit with the population previously unfamiliar with it. In 1970s ceilings on bank lending was lifted. The other developments were personal lending in Scotland was started and the establishment of the four banking groups in England are Barclays Bank, National Westminster Bank, Midland Bank and Loyds Bank. (The Big Four) In Scotland the two groups are The National and Commercial Banking Group and the Bank of Scotland. The Big Four maintain large branch network within the country and abroad. This is in sharp contrast to the American Commercial banking system where unit banks are operating with no branches (some times in some states small branches are operating on a limited area). In Britain the above said banks dominate in the field of retail banking, account for ¾ of all bank deposits by British residents, they have about 13,500 branches, employing roughly about 2 lakh people. In 1979 their deposits were about 70 billion pounds and capital resource was 6 billion pounds

21.4 SPECIAL FEATURES OF BRITISH BANKING

Several authors have streed different apects of British banking system. Robin Pringle has analysed the following features as distinguishing features of British banking. They are

1. It is a Open System

British bankers always looked onwards, to the world beyond Britians shores. It was due to the geographical position and the population of the country. British bankers have to be involved in international trade because England depended on such trade. Again England was ready to welcome foreign merchants and bankers to London. The reason for this was a relatively stable political structure and attractive business environment. On account of this (1) even to-day there are more foreign banks in London than English commercial banks. (2) Deposits of non-residents represent more than half of all deposits with the banks in England. (3) British banks are having largest network of overseas branches.

2. Absence of a Formal Statutory Banking Law

In most of the countries including India banking starts with some type of banking laws. In most of the countries banking system has developed within the frame work of the laws. But in England there are no such laws. Here the bankers are affected by a number general laws relating to the conduct of business. But there are no laws laying down legal requirement or restriction on the kind of business, fixing liquidity ratio, to open branches etc. There is no statute which defines which is a bank and which is not a bank. There is no act of parliament defining bank or regulating it. If any enterprise wants to advertise for deposits and call itself a bank or banker it has to get permission from Department of Trade and Industry. In case of foreign exchange banks they have to obtain permission from Bank of England.

3. Banking is Highly Concentrated

Domestic banking in Britain is highly concentrated. The entire banking sector in the country is controlled by six groups. The groups are (1) Barclays (2) National West minister (3) Midland (4) Lloyds in Britain (The BIG FOUR) and two groups in Scotland (1) The National and Commercial Banking Group and (2) The bank of Scotland. You are going to study something more about the "BIG FOUR" in unit 23. These two groups of banks dominates in the field of retail banking and account for 3/4 of deposits of British Residents. They have more than 13500 branches both in Britain as well as overseas. And Employ about 2 lakh peoples. Because of this high concentration there is some regidity and this regidity has given stability in the banking system. That's why even during the years of dipression there has not been any major bank failure in Britian.

4. Predominance of Private Sector

In Britain all the commercial banks are in privates sector. The only bank in Britain ever to be taken over by the government is the Bank of England in 1946. The other banks which are in the public sector are the savings banks namely National Savings Bank and Trustee Savings Bank. In 1968 The National Giro Bank was established in Public sector and it was granted bank status by the Bank of England in 1978. Since 1975, though it is savings bank, it is providing full banking services.

5. Importance of Conventions

The conventional relationship between the authorities and the commercial banks is a noteworthy of feature the English banking system. The conventions are of two types (1) conventions agreed and up held by between the banks themselves and (2) those which are of official requirement inter-bank conventions or agreements are there in respect of interest rates on advances, interest rate of deposit account etc. But merchant banks, overseas banks and foreign banks, finance houses do not adhere to these conventions. In the case of authorities, their wishes are expressed through request and moral suasion. The most important conventions upheld by monetary authorities relate to advances, holding of assets and so on. In Britain the banks are not subjected to the examination by inspection teams from the regulatory authorities. Because the Bank of England maintains a wide range of contacts and the Governor meets all the chairmen of the clearing banks together every month. This type of historical convention has been followed even to-day. Banking controls have multiplied, but conventions are still followed.

6. Simple and flexible credit techniques

In spite of increasing sophistication of financial affairs commercial banks follow simple and flexible methods in financing. The most common and popular method of short-term finance is overdraft. Here the customer draws on his normal current account up to a certain credit limit permitted by his banker and pays interest only on the net daily overdrawn balance standing in his current account. Even after the enactment of Bank Act of 1979, banking system still following the important elements of flexibility and simplicity in their financial dealings.

21.5 LET US SUM UP

The development of banking system can be traced back to London Goldsmiths. Between 1650-1700 goldsmiths transformed their activities in to bank and in 1694 Bank of England was established in the private sector as a shareholders bank. During 18th Century big joint stock banks were started which are existing even to-day. Banking Act of 1844 and 1979 brought far reaching changes in the functioning of banks, issue of notes. Some important features of British banking system was (1) it is an open system, (2) absence of formal banking statutory banking laws, (3) domestically highly concentrated (4) predominance of private sector (5) importance of convention and simple and flexible techniques followed in financing. Inspite of many development in the banking sector these features an still continuing.

21.6 BOOKS FOR SELF STUDY

1. Money and the Economy	-	John J. Klein
2. Money and Banking	-	Dudley G. Luckett
3. Banking Theory and Practice	-	K.S. Shekhar
4. Money, the Financial System and the Economy	-	R. Glenn Hubbard
5. Economics of Money and Banking	-	Chandler L.V

21.7 QUESTION FOR SELF-STUDY

1. Briefly outline the development of British Banking System.
2. Discuss the highlights of British banking system.

UNIT 22 : BANK OF ENGLAND

Structure

22.1 OBJECTIVES

After reading this Unit you will be in a position to explain

- Evolution of Bank of England
- Organisation of Bank of England
- Functions of Bank of England
- The monetary policy of the Bank

22.2 INTRODUCTION

The Bank of England is the Central bank of England. It act as banker to the government, banker's bank, it issues currencies, advises government on financial matters. Thus in most of its functions the bank acts as an agent of government. It is through this bank monetary policy of the country is implemented. The bank also undertake the management of the national debt and as an agent of the Treasury, the administration of exchange-control. It has set itself as a model to the other central banks of the world. In most of the countries including India, central banks were formed on Bank of England line. In this unit you are going to study the evolution of Bank of England and its functions.

22.3 EVOLUTION OF BANK OF ENGLAND

The Bank of England was founded in 1694, as a joint-stock company, by an Act of Parliament. It's immediate purpose was to provide money for war. The idea of the establishment of the bank organised from an offer made in 1691 by William Patterson supported by several wealthy London merchants for financing the war, the management in return asked the right to issue bills which should be legal tender. However the government refused this proposal. However the plan again came for the consideration which proposed a loan of two million pounds at 7% per annum. Since the government was in need of finance to carry on war with France, Royal assent was given, Governor and Company of the Bank of England was created by an act of 1697.

It was organised with a capital of 1.2 million pounds. The Act extended the Charter upto 1711, after which it was periodically extended. The bank's business during this period was chiefly receiving deposits, discounting approved bills of exchange and advanced money on the security of estates and bullion. Later it undertook from the government the circulation of exchequer bills, the management of the issue of government securities and in 1752 the administration of national debt. During the early years of the Bank, it has to face a lot of difficulties and competition from other banks. But Bank of England proved its capacity to endure severe experience.

At the time of establishment, the bank enjoyed no monopoly of note issue. In the legislation of 1697 the Bank tried to safeguard its interest by preventing the formation of strong joint stock banks. This was severely criticized. Consequently, the Act of 1896 prevented the creation of joint stock banks of issue at a distance of 65 miles from London. The Bank's position as a national institution was regulated and strengthened by Peel's Act of 1844. This Act laid down that no new bank in the U.K. could issue notes. It placed restriction on existing note issuing banks. As a result the Bank of England became eventually the only issuing bank in England and Wales. The Act allowed the Bank of England to issue any amount of notes covered by gold coin or gold bullion. Following the suspension of the gold standard in the 20th century the work and the responsibilities of the bank increased considerably. Expansion of government expenditure and management of national foreign reserve imposed additional responsibilities.

In 1945 the Bank of England was nationalized and it was the first acts of the Labour Government. Private shareholders were given compensation in the form of 3% government securities which are redeemable on or after 1966. The main objective of the nationalization has been to have a greater control over the bank and to make its policies in conformity with the economic policies of the government.

22.4 ORGANISATION OF BANK OF ENGLAND

The affairs of the Bank of England are managed by a board of directors called the Court, which comprises a governor, deputy governor and 16 directors, all appointed by the Crown on the advice of the government. The governor and the deputy governor are appointed for terms of five years and directors for terms of four years. Upto four directors known as executive directors, may be employed full time on the work of the Bank. Members of the House of Commons, Minister of the Crown Civil servants and foreigners will not be appointed to these offices.

22.5 POWERS

Certain Powers have been conferred upon the Bank of England. The Act of 1946 has given specific statutory authority to the Bank to issue directions to the commercial banks, with the approval of the Treasury. But in England, the Bank of England and Commercial banks are working in close cooperation and commercial banks are always ready to recognize the unwritten traditional convention by giving due respect to the request of the Bank of England. Sub Clause (3) of Clause 4 of the Act of 1946 has given specific statutory authority to issue direction, Bank of England seldom uses its official authority. The Bank exercises its influence over the commercial banks mainly through the art of persuasion. Another important aspect of 1946 Act is that the Treasury has been given power to issue directions to the commercial banks after consulting the governor of Bank of England in the public interest.

22.6 FUNCTIONS OF BANK OF ENGLAND

Bank of England like any other central banks performs a number of functions. The functions can be broadly divided in the following ways.

22.6.1 Banker to the Government

As a banker to the government the bank maintains banking accounts for the exchequer and government departments. It borrows on the behalf of government to meet its needs. It undertakes all the responsibilities concerned with public debt. The bank provides the government with advances from time to time. It is the integral part of the Banks duty to grant temporary advances to government.

22.6.2 Advisor to the Government

As an adviser to the government the Bank provides the government with advice and technical assistance on financial operations affecting London Money Market and economic policy. Bank is the channel of communication between the government and the banking world. London is one of the centres for international finance. Because of the importance of sterling in international trading and reserve currency, Bank gives advice to the government on international financial problem. It maintains close contacts with the other central banks of the other countries. It handles various issue of government securities and treasury bills. It maintains government, government guaranteed commonwealth and corporation stocks, payment of dividends, registrations, transfers etc. It acts as the agent of the Treasury in managing foreign exchange resources and administration of exchange control.

22.6.3 The Note Issue

The Bank of England has the sole right to issue notes in England and Wales. Notes are issued on the basis of principle of fiduciary. It means Bank of England issues currency not against gold reserves but against government securities and other securities. The Scottish and Northern Ireland banks have limited right to issue notes, the amount is specified by legislation for each bank; must be fully covered by holdings of Bank of England notes. Although the issue of notes is an important function of Bank of England, in practice the notes are supplied simply on the basis of demand. The coins are produced by the Royal Mint which is a government department..

22.6.4 Lender of Last Resort

This is one of the important functions of 'the Bank of England. Whenever the commercial banks or discounted houses are in shortage of funds they can approach Bank of England as the lender of last resort. In such circumstances the present practice is to rediscount at the Bank Rate eligible bills of exchange or Treasury bills or to lend them money, also at bank rate against eligible bills of exchange, Treasury bills or short term government securities for a minimum period of seven days. Generally, the commercial banks do not approach the Bank of England for financial accommodation. The link is established between these two through discount houses from which the funds are drawn in case of shortage of financial resources. Sometimes to prevent the temporary glut of securities in the market, which may cause fall in the market rate Bank of England follows open back door policy. Here the Bank of England provides temporary accommodation through Bank of England's own broker in the market at a rate that does not disturb the level of market rates. Here the Banks broker intimates the discount houses that they can tide over temporary shortage by bringing Treasury bills to him. These are taken at rate considered by the Bank to represent the market level.

22.6.5 Controller of Credit

The broad strategy and monetary policy is decided by the government in the cabinet. The formulation of general economic policy is conducted by the Treasury under the Chancellor of the Exchequer. The Bank of England is responsible for implementation, co-ordination and application of the government's monetary policy to other banks and financial institutions. There are no special advisory or credit councils as in other countries. Issues of monetary policy are effectively decided by the Treasury and the Bank of England. Now let us analyze the instruments of credit control and their effectiveness.

Bank Rate Policy

The bank rate is the rate at which Bank of England discounts the eligible securities. The twin objective of this instrument is that (1) Bank of England as a lender of the last resort, it has to meet all legitimate requirements of the money market. (2) To curb any unwarranted credit expansion. To achieve these objectives the bank rate was so designed as to make it a penal rate. Prior to 1914 the bank rate was effective, since there was an intimate relationship between the bank rate and market rate. In addition to this, then London was financial centre of world, world's clearing house and only real international market. But after 1914, this instrument of credit control has lost much of its importance and the bank followed cheap money policy. Now every Thursday, Bank of England's Board of Directors meet and decides the bank rate. But now it has been realized that the bank rate is not that effective to control credit. However the Radcliff Committee has suggested that it is better to continue the Bank Rate Policy since it produces psychological effects on industrial sector and banking system.

Open Market Operations

The comparative decline in the effectiveness of the bank rate lead to Bank of England to adopt open market operations. Before 1914, the objective of this instrument was to reduce liquidity in the money market. But during war period it was devised to facilitate the war finance. Since then it has been accepted as an independent instrument of credit control.

According to De Kock, the objectives of open market operations are (1) To make bank rate more effective (2) to avoid disturbances in the money market (3) to support government credit in connection with the issue of new loans (4) to create and maintain conditions of cheap money as an aid to business recovery of war finance.

Selective Credit Control

Selective Credit Control is employed to prevent the flow of credit to less essential purposes. This instrument was employed in U.K. during the Second World War. In U.K. selective credit controls are employed through Treasury request, generally conveyed through the Bank of England. Though the Treasury has the necessary statutory to issue directive on bank credit, it rarely uses this power. Because whenever the chancellor of exchequer makes an appeal English bankers immediately responds positively. In 1951 when he requested that highest priority should be given to export industries and defense programmes to cut down advances for a few months, to tighten hire purchase credit and the banks responded positively. Thus. through request the commercial banks are directed from time to time.

22.7 RECENT DEVELOPMENT IN CREDIT CONTROL

The Bank of England adopted a new approach to the monetary policy in 1971. The aim of the new policy is to improve the competitive environment within banking system and to allocate credit more by price and less by rationing. The central aim of the policy is to control the rate of growth in money stock. In a free system the only way to accomplish it is (1) to make the yield on government securities so attractive that the public to invest in them (2) to allow interest rate on bank lending to rise until only the most worthy borrowers can pay them.

From 1971 Clearing banks had to declare what rates they, individually, would be offering for deposits and charging on loans. Each bank can set its own rate and change not with bank rate, but changes with banks own views of the most profitable rate. The new liquidity ratio is applied to all banks, when all banks have to keep a minimum of 2 1/2 of their eligible liabilities in certain reserves assets like Treasury bills, commercial bills, government securities. In 1981 the minimum lending rate was put into abeyance. Reserve asset ratio was abandoned. Instead of this, all the monetary sector with eligible liability exceeding 10 million pounds has to keep. 0.5 percent of their deposits at the Bank. Thus in this way the Bank of England is following a policy of controlling the rate of growth in stock of money instead of controlling credit in the economy.

22.8 LET US SUM UP

The Bank of England was established in 1694 as a shareholders bank in the private sector. It was established to finance government to meet war expenditure and in return it enjoyed some privileges like issue of notes, discounting bills of exchange, receiving deposits. In 1844, Peel's Act gave the bank more or less monopoly of note issue by preventing other joint stock banks issuing notes. In 1945. it was nationalized and compensation was given to the shareholders. The Bank of England is managed by Governor, Deputy governor and 16 directors. 1946 Act has given specific statutory authority to the Bank of England to issue direction to commercial banks with the approval of the Treasury. As far as the functions are concerned, it acts as banker to the government, adviser to the government, issue notes, lender of last resort. To control credit it employs bank rate policy, open market operations and qualitative methods of credit control. After 1971,the new policy of the Bank is to control the rate of growth in money stock rather than controlling credit.

22.9 BOOKS FOR SELF STUDY

1. Money and the Economy	-	John J. Klein
2. Money and Banking	-	Dudley G. Luckett
3. Banking Theory and Practice	-	K.S. Shekhar
4. Money, the Financial System and the Economy	-	R. Glenn Hubbard
5. Economics of Money and Banking	-	Chandler L.V

22.10 QUESTIONS FOR SELF-STUDY

1) Trace the evolution of Bank of England.
2) Discuss' the organisation and functions of Bank of England.
3) How does Bank of England control credit? Discuss.

UNIT 23 : BRITISH COMMERCIAL BANKING

Structure

23.1 OBJECTIVES

This unit helps you to understand the commercial banking system in U.K. This unit explains,

- Structure of commercial Bank
- Banks which are in private sector
- Banks which are in public sector
- Different banks in the system
- Activities of commercial Banks

23.2 INTRODUCTION

This unit explains the banking system in U.K with Bank of England at its centre and a variety of other banking institutions providing a wide range of services. These institutions comprise deposit banks, discount houses, British over seas banks, foreign banks, the National Giro and the Savings Banks. National Giro banks and the savings banks are in the public sector. Rest of the banks are in the private sector. Commercial banks in U.K are also called as clearing banks or joint stock banks or deposit banks. One important feature of commercial banks in U.K is that they are influenced by practice namely tradition. Because of this banks were criticized for failing to respond to the major challenges, However from 1960s they began vigorously to respond to these challenges and started widening their services, to prune their large branch networks, amalgamated and so on. In this unit let us examine structure of commercial banks first and then the services provided by the commercial banks.

23.3 LONDON CLEARING BANKS

The term 'clearing bank' means only that the banks concerned is a member of the Committee of London Clearing Banks. Four members of this committee are Barclays Bank, National Westminister Bank, Midland Bank and Lloyds Bank. In addition these there are two other member of the committee Coutts and co. and Williams and Glyn's Bank. For many years up to the end of 1969 there were 11 London clearing banks, with Barclays as the biggest one. But following the series of mergers in recent years, this number were reduced to six and the core of the these is formed by the parent banks of the first four great deposit banking groups. These clearing banks account for the bulk of domestic banking activity in U.K. One of the distinguishing features of the British commercial banking system is that the number of banking institutions is relatively small and the number of branch banks are very large. The commercial banks have over 13,500 branches. Since the introduction of the new credit control system in 1971, the distinction between the clearing banks and their subsidiaries has begun to break down.

23.4 OTHER COMMERCIAL BANKS

In addition to the above mentioned commercial banks there are (1) the Scottish Banks which have links with London Clearing Banks (2) the Northern Irish Banks, which are subsidiaries of London Clearing Banks (3) Co-operative banks controlled by London Clearing Banks and the Scottish bank groups.

23.5 THE MERCHANT BANKS

Merchant banks embrace a wide range of activities. In the beginning their main business has been concerned with financing international trade and raising of loans for overseas borrowers by new capital. Today they are very active in the field of domestic financing, in investment management, hire purchase and leasing finance and play an important role in the Euro currency money market. But today the demarcation lines between the functions of merchant banks and those of the commercial banks are less. Because, clearing banks subsidiaries are taking part in installment credit, leasing, term lending and venture capital.

23.6 BRITISH OVER SEAS BANKS

London is the headquarters of a number of British over seas banks. Many of these banks have amalgamated in recent years and the London clearing banks have interest in these banks. There are about 54 banks including commonwealth banks. Most of these banks were established in the 19^{th} century in order to finance the movement and sale of raw materials and contribute to the growth of trade. But after the political independence of many countries these banks became international banks and entered into business like insurance, leasing, retaile banking financing, finance for foreign trade.

23.7 FOREIGN BANKS

In recent years there has been a considerable increase in the foreign banks. Most of these banks have taken the advantage of the opportunities offered in Euro currency market. There were about 143 foreign banks in city of London in 1973. The deposits in foreign banks is that non sterling deposits were more than sterling deposits. These foreign banks operate mainly in the Euro currency market on a larger scale, they are multinational, serving in certain area undertake particular type of banking business. One common feature is that they are joint share holder in a number of firms-mainly other banks.

23.8 THE NATIONAL GIRO BANKS

The post office National Giro was established in 1968 to provide a safe, quick and economical current account and money transfer service. It is operated at over 21,000 post offices. Any person over 15 years age, business and other organisation can open an account with on initial deposit of one pound. Services to individual includes money transfer facilities, for paying household bills, such as gas, electricity etc. standing orders for regular payments of insurance premium etc. It provides range of services to local authorities and to the government departments. Since 1975 it is providing full banking services and in 1978 it was granted listed bank status by the Bank of England.

23.9 TRUSTEE SAVING BANKS

These are local banks and can be found in most of the cities and larger towns in U.K. These banks are essentially regionally based institutions with national structure. These are about 73 savings bank with 1550 branches in U.K. In 1976 by process of amalgamation these number has been brought down to 19. These banks provide unsecured personal loans, temporary over drafts, secured loans, home improvement loans, provide long time savings and investment facilities. Management of these banks remains locally based and sensitive to the needs and interest of each economic zone.

23.10 BANKING SERVICES OF COMMERCIAL BANKS

The commercial banks undertake all normal types of banking business

– deposits, advances, money transmission, discounting bills, foreign exchange.

Current account opens the door to nearly all other services offered. The main task is the receipt, encashment and transfer of deposits. On this no interest is paid, but bank provide services like safe storage, rapid transmission, direct debit, cheque card, credit card. In case of deposit account (time deposit), it is repayable at seven days notice and the rate of interest is paid according to the agreement between commercial banks.

British commercial banks provide investment services like receiving dividends, purchase or sale of securities on behalf of customer. Commercial banks have set up branches specializing in financing foreign trade and taken interest in export houses. They provide complete range of trustee, executor and investment management services.

Settling debts by cheque and the cheque habit is more widespread in Britain. In order to make cheque more popular the clearing banks have issued cheque cards which guarantee to those accepting a cheque up to a certain limit that will be honored. Through credit transfer system a customer with many payments to make can instruct his bank to transfer to the bank accounts of his creditors the amount due from him.

The first credit card scheme was Barclay Card offered by Barclay Bank. It is intended for the use of house wives, and other shoppers and business men. In 1972 big commercial Banks jointly owned credit card organisation launched Access Card. The most popular form of bank borrowing in U.K is by way of overdraft. For businessmen the limit is renegotiated every six months or every year.

Automatic cash dispensers are being installed in the main towns and other centres. Travellers cheques are provided by all commercial banks. In case of export finance, the banks provide through overdraft facilities. The commercial banks have connection with overseas banks, both British overseas banks and with foreign banks which has helped these banks in export finance.

Finally the London Bankers Clearing House provides a simple but effective way of dealing with the clearing of cheques. The length of time taken to clear a cheque varies from one to five days. Each day the head office of each commercial bank sends to the clearing house the cheques drawn on other banks which have been paid by customer at this branches. These are twelve clearing houses in the provinces to deal with local cheques.

23.11 THE "BIG FOUR" COMMERCIAL BANKS

One of the important features of the commercial banking system in U.K is the small number of big banks. Though the committee of London Clearing Banks have six members, among them Barclays, Lloyds, Midland and National Westminister are the important. Often they are referred as the 'Big four'. The big four are all public companies, and their shares are held by a wide range of investors. The following are the some details of the big four banks.

1. Barclays Bank

This bank has been operating as a private bank since 1736. This bank is operating in the eastern half of England. After absorbing several private banks, very rapidly it expanded to national status. Barclays also had substantial holdings in several large overseas banks. Its stake in the international field was established in 1967 and offers specialized help to exporters. 1966 it launched the first Barclay credit card in the country. In 1971 the number of deposits was 3.3 million with total assets of 4045 million pounds. In the same year it had 3000 branches and employed about 80,000 people.

2. Lloyds Bank

This bank was established in 1765 in Birmingham. This bank flourished in growing wealth and prosperity of Birmingham and converted in to a joint stock bank in 1865. It is having 2400 branches, 2.5 million accounts and employs about 3400 people. It has introduced computers and many ancillary services. Other services are cheque cards, executor ship, management of pension funds and operates its own unit Trust which can be bought and sold over any branch counter. It operates in the money market and under take medium term lending. It has overseas branches and handles a massive volume of foreign business. It also has a share holding in a number domestic and foreign banks.

3. Midland Bank

Midland Banks was established in Birmingham in 1836. This bank was survived inspite of many bank failures between 1840 and 1870. After amalgamation of smaller bank 1891 it ventured into London and in 1918, it become joint stock bank. Apart from the main overseas branches in London with 1300 staff and 20,000 banking correspondents and agents all over the world. It has some 2,700 branches in England and employee about 50,000 people. This bank and its affiliates provide worldwide financing in sterling, participate in joint venture in major capital projects, finance aircrafts and ship in addition to the other banking activities. Its deposits are about 3 million and having 3.5 million pounds of assets.

4. National Westminister

It was formed in 1968 after merging three large banks of 1820s and 1830s. This bank has now 3400 branches with 58,000 employees. This bank is internationally linked with other large banks. It provides large scale finance for multinational companies. It is having branches and subsidiaries in Europe. It is having 6068 million deposits and its assets are about 6648 million pounds.

23.12 LET US SUM UP

Commercial banks is U.K are also called as clearing or joint stock bank or deposit banks. Here banks are more influenced by the tradition rather than the bank laws. The banks in U.K can be grouped under two heads. (1) London Clearing Banks consisting of the big four banks, Barclays, National west-minister, Midland and Lloyds and Coutts and William and Glyn's Bank. The other banks which are outside the London Clearing Banks are Scottish and Irish Banks. Apart from these banks there are merchant banks, British overseas Banks and foreign bank. One of the features of the British banking system is that all the banks are in the private sector. It is only Bank of England, the National Giro Bank and Trustee savings banks are in public sector. As for the structure is concerned the banks are following branch banking sytem. The 'Big Four' are having branches not only throughout the nation but also branches in foreign countries. The commercial banks under take normal type of banking business. To meet the needs of the increased and more diversified business banks are making extensive use of sophisticated management information system such as system analysis, operational research computer modelling, teller machines, credit card, e-banking etc.

23.13 BOOKS FOR SELF STUDY

1. J.N. Mongia	-	Banking Around the World
2. Robin Pringle	-	Banking in Britain
3. K.C. Shekhar	-	Banking Theory and Practice
4. Kettel	-	Monetary Economies
5. Sayers R.S	-	Modern Banking

23.14 QUESTIONS FOR SELF-STUDY

1. Explain the Banking System in U.K
2. Write a note on
   (a) The Big Four
   (b) Services of Commercial Banks

UNIT 24: LONDON MONEY MARKET

Structure

24.1 OBJECTIVES

After reading this unit you will be in position to understand the

- Concept of money market
- Structure of London money market
- Official and parallel money markets
- Sub market in the London money market
- Credit instrument dealt in the sub-money market

24.2 INTRODUCTION

A money market is a mechanism which makes it possible for borrowers and lenders to come together. Money market refer to a market for short term funds. It does not refer to any specific place. It may be located in a particular place where short term funds from an entire region or country are attracted. In United Kingdom, London is an import city where short term flows not only from different parts of U.K, but also from different countries of the world. Hence it is called London money market. This market is a well developed and organised money market. In this unit you are going study about London Money Market, its submarkets and credit instruments dealt in these markets. London Money Market can be broadly divided into traditional or official or discount market and secondary or parallel money market. Now let us examine these markets in detail.

24.3 OFFICIAL OR DISCOUNT MARKET

This market provide means for short term investment of sterling liquid funds. Bank of England, commercial bank, discount houses, acceptance house issue house, merchant banks participate in this market. Bank of England plays an important role in this market and participate as lender of last resort to discount houses. The interest rate of this market is the official interest rate, funds in the market are secured one and less role for the middle men. Sub markets in this market are discount houses, accepting houses, issue houses and merchant banks. Let us study these markets in detail.

24.3.1 Discount Houses

In London Money Market 'Discount Houses' enjoy a key position.

The discount market is made up of 12 discount houses. Each of these is a public company and is independent of other financial institutions. Of these the oldest is that of Gillet Brothers Discount Co. Ltd., the National Discount Co. Ltd., and the Union Discount co of London Ltd. The main business of the discount houses consisting of trading in and holding commercial bills of exchange, Government Treasury bills and securities with a life up to five years.

Capital

The capital of the discount houses is relatively small in relation to the volume of their operation. The houses exist by borrowing money. They invest this money in short term bills expected to yield a slightly higher rate of interest than the cost of their funds. Generally discount houses invest mainly in Treasury bills, commercial bills and government securities. For many years they borrowed most of their money from big banks. Since 1971 they borrowed larger sum from over seas, foreign and merchant banks. In case the bank withdraw their loans, they can approach the Bank of England as the lender of last resort. If the overall supply of money is insufficient on any day for a discount house, the Bank of England can relieve the shortage by buying bills. The commercial banks in U.K do not generally approach the Bank of England for financial accommodation. The link between Bank of England and commercial bank is established through the discount market which is the first outlet of any surplus funds held by the commercial banks and withdraw from the market if they find necessary. The total amount of loans to this market is about 1000 millions pounds.

Functions

The discount houses perform some important function. They are;

1. By discounting bills, discount houses bridge the time element between the sale and the actual payment of money. This enable the seller to carry on his business without any hindrance, and buyer gets enough time to realize the money.

2. It provides a system which the ebb and flow of cash in the banking system can be evened out. In England, traditionally, the big deposit banks did not borrow from one another, but instead lend to the discount houses.

3. It is a channel through which the Bank of England provides additional new cash to the system if there is a demand for it.

4. It provide a specialized market for buying and selling of accepted bills of exchange and other money market instruments.

5. By buying bills of different maturities from the discount houses, the commercial banks can arrange their bill portfolios in such a way that some bill mature every day. This increases the liquidity of the banks.

6. Finally the endorsement of a bill by the discount houses increases the security of the bills.

After the First World War the increasing use of bank over drafts and other factors, greatly reduced the use of bills of exchange to finance inland trade. But the treasury bills partly solved this problem. These bills are short term bills issued by the government, generally for periods of 91 days. The discount houses use to acquire these bills at the weekly tenders and commercial banks with surplus fund use to buy these bill from discount houses. But during the 1930s the yield on both commercial and treasury bills declined very sharply. As a result the discount houses tended to trade and invest increasingly in short-term government securities with not more than five years. By 1972 because of surplus in the government finances caused a fall in the supply of treasury bills. The outstanding feature of those years was the revival of the commercial bill. The supply of these bills increased because the traders found difficult to obtain credit from other sources. In 1969, the commercial bill represented 40% of this total assets. Thus the discount market has faced many challenges to its prosperity and even its existence during its long history.

The secret of its survival has been to readiness to adapt to new conditions. New the discount houses have diversified their activities. They have developed interest in firms of money brokers in new sterling money markets or in foreign currency deposit dealing in new paper assets, such as local authorities bonds, and operations in foreign currency bills of exchange and dollar certificate of deposits.

24.3.2 Accepting Houses

The "Accepting Houses" are another important constituent of the London Money Market. The term accepting house strictly applies to the 18 members of the Accepting House Committee. These houses are specialized agencies who under take the business of acceptance. They accept bills on behalf of the importers. One of the main functions of the merchant banks has been and remains the lending of their names by accepting bills of exchange. The function of accepting house can be explained with help of an example. Suppose that an Indian merchant purchase goods from an English merchant. The exporter draw a bill of exchange on the importer. But the English exporter may not be sure of the credit worthiness of the Indian importer. Moreover the exporter may find it difficult to discount the bill accepted by a foreigner. But if the bill is accepted by a firm which enjoys considerable reputation in the London Money Market, it can be readily discounted.

Accepting house, accepting a bill should be a firm enjoying considerable reputation. Otherwise, the discount houses will refuse to accept. On accepting the bill, the responsibility to meet it on the due date falls on the accepting house. The accepting house collect commission for lending its name to the bill. Before granting an accepting credit, the Accepting houses call for the necessary information regarding market conditions, the credit worthiness of the proposed client. For this purposes the accepting houses have their representatives and agents in foreign countries and they will be well acquainted with the financial standing and credit of the various business houses. These representatives provide all the information to the Accepting houses. After knowing the credit worthiness of the client, then the accepting house accept the bill on behalf of its client.

In addition to the accepting bills, the accepting houses will under take other business. They are (1) normal banking transactions, (2) the investment of funds and safe custody of securities for account of clients in U.K and abroad, (3) dealing in foreign exchange, (4) covering marine and other insurances, (5) issuing long term loans for governments of and institutions in overseas countries, (6) issuing and placing shares and disbentures for British and other companies, raising capital in the London Market, (7) carring out transactions in gold and silver, (8) keeping registers of share holders and debenture holders for British companies. But a accepting house may not take part in all the above said activities. In addition to accepting bill it may under take one or two functions mentioned above.

24.3.3 The Issuing Houses

The Issuing houses are those institutions which specialize in transactions concerning the capital of companies, in particular, the sponsoring of capital issues on behalf of their customers. The institutions which involve in this activity are accepting houses, merchant banks and other banks. The main function of issuing house is to obtain capital from public for their clients. The issuing houses make themselves responsible to their clients for the funds they require. Before this the issuing houses study the terms and conditions, viability of the project or industry. After satisfying themselves they obtain required funds from the public for their clients. Although the issuing houses have large resources, they do not generally provide more than a limited proportion of any issue. Because, they act as sponsors and under writers rather than as a source of finance. For this purpose the issuing houses usually makes arrangements with a wide circle of institutional investors for the sub-underwriting.

Since 1945 the issuing houses are playing an important role in raising of new capital for commence and industry. As intermediaries between takers and providers of capital, they perform important service to both. In addition to raising capital, they act as financial advisers on amalgamation, reorganizations, capitalization of reserves, acquisition of other businesses, the setting up of subsidiary companies in U.K etc. They also advise on the law and practice governing new issues and rules and regulation of the stock exchange. To the investors they are guarantee that the issue is made on a legal and proper basis.

24.3.4 The Merchant Banks

The title 'merchant bank' is difficult to define: it has no judician significance but is in widespread use. Very broadly these banks provide specialist services for industry and commerce. But the business of merchant banks in changing rapidly. Traditionally, their main business has been concerned with acceptance credit for the financing of international trade and the raising of loans to overseas borrowers by new capital issues. But today they have embraced a wide range of activities like domestic financing, advising on amalgamations and takeovers, investment management, hire purchase and leasing finance, equity participation, term loan raising and also play an important role in the Euro currency market. At present accepting houses, issuing houses, clearing group banks and such other institutions come under this category.

Their deposit banking activities and their operations in the money markets are exclusive. Their deposits from other U.K banks have increased sharply. As home based banks, they keep a high proportion of sterling deposits in liquid form. They maintain large balance with other U.K banks and lend to

U.K local authories, part of the balances with other U.K banks are in foreign currencies. Euro dollars deposited with them in London is lent out again to overseas residents. At present there are about ten important merchant banks oldest being Baring, deposits having worth 143 million pounds.

24.4 THE PARALLEL MONEY MARKET

Parallel or secondary money markets have developed in short term funds along traditional short term money market. Parallel money market are dealing mainly in foreign currencies deposits of non-residents, the sterling deposits of non-residents or the surplus of sterling funds held by the domestic banks. Merchant banks, discount houses and the British and foreign banks, London clearing banks are there in these markets. Bank of England will not participate in this market. Brokers or middlemen will be very active between the lenders and borrowers. Britian and other countries removed the official restriction on the movement of short term funds in 1950s. In 1958 convertibility of external holders of current sterling was allowed. All these factors encouraged the short term funds to move in and out of London Money Market is response to changes in the interest rates. A high level of interest rate offered by merchant banks and credit restriction on commercial banks hampered the traditional financial activities and encouraged the new or the secondary market. Parallel market consist of (1) The Euro currency market (2) certificate of deposits market (3) inter bank sterling market. Let us examine these markets in detail.

24.4.1 The Euro-Currency Market

The term Euro-Currency is used to denote a deposit accepted by a bank denominated in a currency other than that of the country in which that bank is located. In otherwords, Euro-currencies are the bank deposit liabilities denominated in a currency other than the currency of the country in which the bank accepting the deposit is located. It means any currency accepted by a bank outside the country of issue of the currency is a Euro Currency. For example U.S dollar deposits accepted by a bank in London. Merchant banks and the exchange banks are active in this market.

Euro-Currency market is essentially a short term money market for borrowing and lending in Euro Currencies 1950s and 1960s U.S balance of payment was in deficits. Because of expansion of foreign trade and foreign investment, demand for dollars increased. In 1960s interest ceiling were imposed on deposits. Therefore American residents placed their deposits with Europian Banks willing to accept dollar deposits at a higher interest rate than that of American banks. This resulted in decline of funds in American commercial banks and they began borrow from Euro-dollar market. Since then the Euro currency market was rapid and grew both in size and variety. The market now deals in major currencies such as Euro-sterling, Euro-marks, Euro-yen, Euro-swiss francs etc. Since 1963 there has been an increasing number of long term loans. Central banks, international organisations, multinationals, financial institutions, business corporations, oil producing countries are the major depositors. Major borrowers are governments, financial institutions and multinationals. London is the largest Euro-currency market where about 250 banks deals in foreign currencies.

24.4.2 Certificate of Deposits

The negotiable dollar certificate of deposit was introduced in London in 1966 and other banks were quick to follow. Certificate of deposits are usually bearer securities issued for minimum amount of 25,000 dollars in multiples of 1000 dollars. Maturity period ranges between 180 days to one year. The interest is not fixed, but floating as it is linked to London inter bank offered rate. The merit of the certificate of deposit is that the holder can draw the funds before the deposit matures by negotiating or selling the certificate in the market.

24.4.3 The Inter Bank Sterling Market

The inter-bank sterling market activities consists of the placing and taking of sterling deposits between London banks including the overseas banks. In 1964 foreign banks were reluctant to hold sterling deposits in London. The high interest rates on local authority loans provided attractive investment opportunities. The inter-bank sterling market utilized a further source of credit. If clearing banks develop large surpluses, this market absorb the surplus and avoid official action of Bank of England.

24.5 LET US SUM UP

London money market is highly developed money market not only for Britain but also for the different countries of the world. This market can be broadly divided into traditional or discount market and secondary or parallel money market. In traditional market the sub markets are discount houses, accepting houses, issuing houses and merchant banks. In this market Bank of England participates and helps the money market by providing necessary funds. In parallel market it will not participate. Parallel market is a market which deals in foreign currencies and deposits. The sub-markets in this markets are Euro currency market, certificate of deposits market and inter bank sterling market.

24.6 BOOKS FOR SELF STUDY

1. J.N.Mongia	-	Banking Around the World
2. Robin Pringle	-	Banking in Britain
3. Kettel	-	Monetary Economics
4. K.C.Shekhar	-	Banking Theory and Practice

24.7 QUESTIONS FOR SELF-STUDY

1. Explain the constituents of London Money Market.
2. Examine the significance of Discount Houses in London Money Market.
3. Write a note on parallel money market.

NOTES

UNIT 25: AMERICAN BANKING SYSTEM

Structure

25.1 OBJECTIVES

After reading this unit you will be in a position explain the American Commercial Banking System. It helps you to understand evolution, types of banking, the features of commercial banking and various banking legislations to control and establish a sound banking system in America.

25.2 INTRODUCTION

American banking system is composed of many forms of commercial banking. There are different types of bank and different types of banking. There is dual control of banking i.e controlled by respective states and banks controlled by Federal Reserve Banks. Above all the banking industry is highly regulated through many banking legislations from time to time, with the object to establish a sound banking system in the country. Inspite of many regulations banking failures are common even today. We will try to understand all these aspects in this unit.

25.3 EVOLUTION OF BANKING

Evolution of banking in America can be traced back to 17th century where land banks were existed. These banks were operated by colonial governments. These banks used to issue paper currency as loans on various kinds of lands and real estates. During the first half of 18th century, groups of traders and merchants organised private banks to discount short term commercial bills and issue private bills of credit. These bill of credit were very popular with the public since they used to be paid off punctually in specie. In 1791 an attempt was made to establish a nationwide banking system. It was called the First Bank of United States as a lending bank. Because of distrust of agriculturist and small business interest it was closed in 1811. In 1816 the Second Bank of United States was formed. Because of political reasons its charter was not extended and hence it was closed in 1836. After 1836 the states were given the right to control banks within their states. In 1838 the Free Banking system was inaugurated. It permitted any person or group of persons to enter the banking field so long as they followed safety requirements of state act. These banks were relatively successful and lasted until the passage of the National Banking Act of 1863.

National Banking Act of 1863 established Federally chartered banks, known as national banks and were allowed to issue currency. But the act had a number defects. The economic crisis of 1907 resulting from bank failures, in which savers lost their deposits and borrowers found it difficult to raise funds. This lead to the creation of Federal Reserve system. It created 12 Federal Reserve Banks. But from 1921 to 1933 more than 11,000 banks failed. This lead to the creation of Federal Deposit Insurance Corporation to protect the interest of the small depositors through the Banking Act of 1935.

25.4 TYPE OF BANKS

American banks can be broadly divided into.

1. Member Banks: It is a member of Federal Reserve System. These banks are charactered banks and under the control of Federal Reserve Banks. These banks are national in character found in all the states.
2. Non-member Banks: It is a bank which is not member of Federal Reserve Systems. These banks functions with less capital, lower reserve ratios, not audited by the Federal Reserve Banks but maintains relationship with Federal Reserve Banks through correspondents.
3. National Bank: A bank that hold a charter from the Federal government. It must be member of Federal Reserve system. Minimum capital requirement are laid down for banks and minimum reserve to be maintained according to the location of banks.
4. State Bank: A bank that has a state charter. State Banks may or may not be members of Federals Reserve System. Generally these banks are owned by respective states. In some cases capital is wholly subscribed by public sector.
5. Insured Bank: A bank whose deposits are insured by the Federal Deposit Insurance Corporation. Membership is compulsory to member banks.
6. Non-insured Bank: A bank whose deposits are not insured by the Federal Deposit Insurance Corporation.

25.5 STRUCTURE OF AMERICAN BANKING SYSTEM

American banking system can be divided into unit banking, group banking, chain banking, and corresponding banking. Let us examine these banks and their features.

25.5.1 Unit Banking

America is unique among industrial nations of the world is having largely of unit banks. Unit bank means it is single commercial bank operating a single banking office. It is not controlled by another bank and does not itself control another bank. Generally unit banks are locally owned and managed. In America there were 14,404 banks in 1980. Ofcourse this declined to 10,300 banks is 1995. The reasons for the establishing units banks are (1) American free enterprise has encouraged establishment of many small banks. (2) Untill recently large areas of America were under populated the great distances between populated centers, the difficulties in travel and communications fostered the development of unit banks. (3) The banking laws prevented the centralization of banks to prevent monopoly in banking. (4) The fear of share holders is another reason. In the beginning share holders did not like branch expansion fearing that they may loose control over the banks and there by they may loose their capital. There are many advantages and disadvantages of unit banking. This we have already discussed is block II unit 3.

Though America is a predominantly unit banks system country, it does not mean that branch banking is unknown. With the expansion of the economy there was a need for banking facilities and to meet the needs of the community existing banks opened branches. But the extent of branch banking is controlled by the banking laws of the state governments. National banks are allowed to establish branches only to the extent permitted by the state where it is located and they are not allowed open branches outside the states. Some states permit unlimited statewise branches while other prohibit branching of any kind. Thus unit banking is still dominant in over 1/3 of states. Almost 1/3 of the states permit a bank to establish branch only within the state. In 1950 out of 14,146 banks 12905 were unit banks and 1241 banks were having 4721 branches. In 1974 out of 14178, 9948 were unit banks, 4724 banks had 26246 branches. Thus despite of the growth in branch banking, the essence of unit bank has been preserved. Statewide branch banking in still relatively rare in America.

25.5.2 Group Banking

Group banking is a legal form of bank organisation where two or more independently incorporated banks are controlled by a holding company. A holding company is corporation which owns stocks in other corporations.

One holding company may consist of five separately charactered banks, with controlling interest in stock of each banks. There are no restrictions on the types of banks that may belong to a group and group banking is not confined within the state.

The main reason for the establishment of group banking has been restrictions put on branch banking by the state government. Group banking is, to a considerable extent, a substitute for branch banking. The Banks Holding Company Act of 1956 clarified the status of group banking and there by fostered its growth. Holding companies are two types. They are multibank holding companies, which control the stock of two or more banks and one bank holding company which control the stock of only a single bank.

The advantage of group banking are, economies of scale, better customer services, greater mobility of founds, better management, training programmes. The disadvantages are, it concentrates banking power, decreases competition and it is not concerned with the problem of small financial centres.

25.5.3 Chain Banking

Chain banking is term used to describe the association of a number of commercial banks through an interlocking directorate. Here same individual, same members of family own two or more banks by common membership on the board of directors of the banks. There is eventually no state or federal legislation specifically dealing with chain banking though the anti trust acts can be used where there is monopolistic abuses are there. Most chain banking system are apparently rather small, involving only two or three banks. In 1880s it was popular in South and Central North West. But since 1920 it is on decline.

25.5.4 Correspondent Banking

A correspondent bank is one that maintains deposit account for other smaller, customer banks. Generally small banks is small places, keep deposit in nearby city banks, these banks in turn hold deposit in big banks in cities like New York. Small banks maintain these deposits because of the variety of services provided by the larger banks. The service are (1) Clearing and collection of cheques for both member and non-members banks. (2) Security reason (3) Handling of bond and security purchase (4) Participation in loan that the small banks cannot handle (5) making of loans to customer banks. Thus though America is predominately a unit banking country, but unit banks are well connected with another and helps in the payment throughout the country through correspondent bank.

25.5.5 Special Feature of commercial Banks

1. Although the United States has the world's largest economy, U.S. banks are not large by international standards. Only one of the top 30 banks in the world in 1995 is a U.S. bank. Japanese and European banks are generally are much larger than the largest U.S. banks.
2. U.S. banking industry has an enormous number of banking firms. In 1995 there were about 10,300 commercial banking firms in U.S. Where as Japan had 700 banks and Canada had only eight major banks. U.S. has about 45 banks per million, compared to slightly more than one bank per million. In case of money market there are 14000 clearing house in U.S. compared to only 10 in Britain.
3. U.S. banking industry is not as concentrated as that in other countries. The share of U.S. deposits held by the five largest banks is less than 20% of their counter parts in Japan, Canada and Germany.
4. Because of its importance in the functioning of the economy commercial bank in U.S. is a highly regulated business. There is dual banking system in the sense that commercial an controlled by two authorities. National banks obtaine charater from federal government and the State Banks from their respective state governments. The laws governing national banks are different from than those of state banks and the banking laws of each state are different than those of every other state.
5. Competition among commercial banks in deposit mobilization in restricted because of restrictions on branch banking. Commercial banks are not allowed to offer the range of services offered by new banks financial intermediaries like insurance, corporate security under writing, brokerage services . In addition to this commercial banks were at a disadvantage in their competition with thrift institutions like credit unions, mutual savings banks, savings and loan associations etc. which offer higher interest rate on savings, compared to commercial banks.

25.7 BANKING REGULATION IN U.S

Banking in U.S. is a highly regulated industry and it is regulated in a unusual way. Here the regulation of commercial banking has taken the form of laying down certain operating rules that banks must follow, such as a new bank may be opened in a particular locality, type of investment a bank can make with depositors money, the type of business a bank may engage in. The reason for this is the basic weakness in the banking system has historically been its instability. Even in the relatively prosperous decade of 1920s hundreds of banks failed each year. In the depression days of 1930s thousands of banks failed every year. Therefore, to stabilize the banking industry on sound principles and to eliminate bank failures made bank regulation necessary. Let us briefly study the various regulations and regulatory agencies.

The development of banking in U.S has been shaped largely by government action. In 1791 congress chartered the First Bank of the United States. This bank was designed to be a source of currency convertible into specie and to operate both as commercial bank and as fiscal agent for U.S. government and acted as central bank by regulating state bank note issue. Since large volume of bank stock was held by foreigners the congress failed to renew in charter in 1811. Between 1811 to 1816 State Bank entered the field. Because of speculative excesses and inflation state banks proved unsuccessful. In 1816 second Bank of United States was established. Since it was badly managed it was closed down in 1836. The period from 1836 to 1863 was era of state banking. Since there was no central banking, financial chaos existed throughout the period.

In 1824 the Suffolk System was established and it was successful in maintaining a convertible currency by redeeming notes. The safety Fund System came into existence in 1829 to protect depositors in the event of bank failure. The Free Banking Act of 1838 permitted any group of people to set up a bank provided they deposited state and United States bond. During the state bank period from 1836 to 1863, there was absence of uniform currency and a central bank. This led to financial chaos.

25.7.1 National Banking Act 1863

The frequent failure of banks to redeem the notes issued by them and consequent currency depreciation led to the enactment of the National Banking Acts in 1863 and 1864. These acts did not reinstate centralized regulation of banking, but they did correct some of the deficiencies of the state banking. The main object of the National Banking Act was (1) to stimulate the government bond market in order to enable the government to obtain the necessary funds and (2) to establish a sound currency system backed by government obligation. It is probable that the financial pressure of Civil War caused this banking legislation to be passed. According to the terms of this act national banks were to be established that would issue paper currency and provide a market for U.S. government security.

Main provisions of the Act.

1. Any group of five or more persons could apply for a character from comptroller of currency in Washington before starting business. Banks which received character from comptroller were called 'National Banks'. National banks were different from state banks which received their charter from the state government authories. This distinction between national bank and state banks is there even today. Comptroller of currency was given considerable supervisory power including authority to grant or withhold a charter or to inspect national banks.
2. The minimum capital requirement for the establishment of national banks was prescribed. (1) 50,000 dollars for banks in cities with less than 6000 people. (2) 1,00,000 dollars for banks in cities with 6000 to 50,000 population (3) 200,000 dollars for banks in cities with population more than 50,000 population. Some 50% of capital has to be paid before starting of banking business and rest was to be paid within five months. Banks are required to transfer at least 10% of their net profit to reserve fund until the reserve fund equals to the capital stock.
3. Before starting banking business a bank was required to deposit U.S. government securities worth 30,000 dollars or one third the value of banks capital stock. Once the bonds were delivered to the Treasury the banks could start issuing national bank currency in an amount equal to 90% of the value of securities. In addition, each national bank was obliged to redeem the notes of any other national bank at par. No national bank could issue currency in excess of the value of its own stock.
4. The Act required national Banks to maintain a statutory cash reserves proportionate to the amount of its liability on deposit account. For reserve requirement purpose banks were divided in to central reserve

city banks, reserve city banks and country banks. For central reserve city banks the reserve ratio was 25% on their bank note and deposit liability and for country banks it fixed at 15%. On 1874 the reserve requirement for notes was dropped and reserves were required only for deposits.

Thus the National Banking Act succeeded in providing safe, uniform currency. Although the number of state banks declined substantially due to the competition from national banks, those state banks remained in business continued to issue currency in excess. To correct this congress passed an act in 1865 and imposed annual tax of 10% on all state bank note issue. The tax was so prohibitive that within a few years all the state bank note issues were withdrawn from the circulation and the number of state banks declined. The growth of national banks were substantial and between 1900 and 1913 there was an average yearly increased of 294 national banks. By 1995 there were 3300 national banks and 7000 state banks were there.

Defects of National Banking System

National Banking System marked a long step forward by providing relatively safe banking facilities and a standard bank note. But it had a number of defects. They are;

1. The notes issued by National Banks were inelastic in nature. A growing economy needs additional currency and deposits to carry on growing volume of transactions. Under this Act there was no mechanism for automatic note expansion. The issue of currency was not based on the needs of the economy but it depended on government borrowings. This is because the banks issue of notes depended on U.S. government bonds.
2. Another major defect of this Act was accumulation of reserves (Vault Cash) The ultimate reserve of all national banks was used to redeem deposit liability. It was not used for the purpose of helping a bank in an emergency.
3. National banks failed to provides adequate credit facilities to the agricultural population. The high capital requirement of National Bank discouraged the establishment of banks in such areas. Even in places where national banks were existed, the law prohibited from lending on real estate or lending for more than 90 days. As a result agricultural population depended on state Banks which used to charge high interest rate.

4. There was also the complaint that the national banking system encouraged flow of funds from where they had been accumulated to large financial centres, where often they were used for speculation purposes.
5. Rigid reserve requirement is another defect. Whenever National Bank was short reserves it was required to suspend granting of new loans. This regulation created uncertainty for both borrowers and bank managers.
6. Clearing and collection mechanism for cheques employed by the National Banking System was outdated one. There was no central clearing agency. With a unit banking system consisting of thousands of banks, cheques had to be cleared through an elaborate network of correspondent banking relationship and this type of clearing facilities were cumbersome. The cost of transferring funds between distant points was expensive and is to take long time.

25.7.2 Federal Reserve Act of 1913

The defects of National Banking System became glaring during the panic of 1907 and indicated that the U.S financial system was unstable. After the 1907 panic and economic recession, congress considered option for government intervention and appointed a National Monetary Commission to design a central bank for U.S. It submitted its report in January 1912. The Federal Reserve Act was passed in 1913 and it established Federal Reserve System. The object of this Act was to provide for the establishment of Federal Reserve Banks a regional system of central banking system to furnish elastic currency, to rediscount commercial papers and to establish a more effective supervision of banking in U.S. Under the act National Banks are required to become members of the Federal Reserve System. State Banks may join provided they have capital. The Federal Deposit Insurance Corporation was established to provide insurance to deposits in 1934.

The defects of the U.S banking system were clearly demonstrated in 1920s and in 1930s. From 1921 to 1933 more than 11,000 banks failed. So the Banking Act of 1933 was passed. Accordingly (1) mutual savings banks having surplus and undivided profits were allowed to become members (2) branch banking was allowed within the state, where state banks was permitted to open branches (3) Federal Open Market Committee was created, and more power was given to Federal Reserve Board to control Federal Reserve Banks.

The Banking Act of 1935, reorganized the Federal Reserve Board with a seven member Board of Governors and given power to alter reserve requirement of member banks within limit, over rediscount rates and open market operation. The International Banking Act is 1978 provided a uniform national policy for foreign banks. The Depository Institution Deregulation and Monetary Control Act of 1980 treated all institutions including bank and non-bank financial intermediaries more equitably in respect of reserve requirements, banking services, interest ceiling and form of deposits available to the customers.

25.7.3 The Federal Deposit Insurance Corporation

In 1933 U.S. experienced the worst banking crisis in its history of banking. In that year 4000 commercial banks suspended their operations and thousands of people lost their life savings. This resulted in the establishment of the first nationwide system of deposit insurance under the provision of Banking Act of 1933. The establishment of FDIC in 1934 marked the recognition of bank failures as a national problem, one which could be successfully solved only at federal level.

According to the Federal Deposit Insurance Act of 1950, all banks belonging to the Federal Reserve System must be insured with FDIC. A member bank in the Federal Reserve System which looses its insured status is not permitted to continue as a member and it has to give up its federal chapter. State Banks and mutual savings Banks which are not members of Federal Reserve System may have their deposits insured provided they satisfy the requirement of FDIC. The FDIC may expel a bank from the system for following unsafe and unsound practice. There is a provision for the inspection of insured banks.

The FIDC is administered by a board of three members comprising the comptroller of currency and two others appointed by the President with the consent of the senate for six year term. The directors must have no connections with any bank as directiors, officers or stock brokers during the tenure of their office. The capital was subscribed by the Federal Government and Federal Reserve Banks, and annual insurance premiums paid by its member banks. By Statute, the premium for each bank is set at 1/12 of 1% of its total deposits. The FDIC insures the deposits of its member commercial banks to a maximum of 40,000 dollars. The FDIC is quite successful in imposing uniform standards of sound banking management throughout the banking system, in particular on the small state chartered banks that do not belong to the Federal Reserve System. However bank failures has remained a problem in U.S. in 1990s. In 1989, 205 banks failed and in 1991, 104 banks failed in 1991 the assets at failed banks were 46.7 billion dollars. But by 1994 the bank failures had become much rarer.

25.8 LET US SUM UP

American Banks started with the establishment of land banks during colonical period. Then in the beginning of 18th century merchant and traders established private banks to discount commercial bills. In 1791 attempts were mode to establish nationwide banks. After the failure of the First and Second Bank of United States, state banks were established by the state governments. Since these banks were not properly managed and controlled crises in the banking system continued. To establish banks on sound principles and to prevent depreciation of currency National Banks were established through National Banking Act of 1983. Because of many defects in the Act it led to panic in banking system in 1807. This lead to the appointment of National Monetary Commission to advise for the establishment of central bank for the country. Accordingly 1913 Federal Reserve Act was passed and Federal Reserve System with regional central banking was established. However the failures of banks in 1920s and 1930 continued and to remedy the failure of bank, banking act was passed in 1933, and 1935. To protect the interest of the depositors in the event of bank failures, the Federal Deposit Insurance Corporation was established in 1934.

25.9 BOOKS FOR SELF STUDY

1. Money and the Economy - John J. Klein
2. Money and Banking - Dudley G. Luckett
3. Banking Theory and Practice - K.S. Shekhar
4. Money the Financial System and the Economy - R. Glenn Hubbard
5. Economics of Money and Banking - Chandler L.V

25.10 QUESTION FOR SELF STUDY

1. Explain the evolution of banking in U.S.
2. Discuss the structure and features of commercial banks in U.S.
3. Highlight the features of National Banking Act of 1863 and its defects.
4. 'Banking Industry in U.S. is highly regulated industry' discuss.

UNIT 26: FEDERAL RESERVE SYSTEM

Structure

26.1 OBJECTIVES

The Objectives of this unit is to acquaint you with the Federal Reserve System in U.S. You are going to learn about the central banking in this system, its organization, different bodies like Board of Governors, Federal Open Market Committee, Federal, Reserve Banks and their functions.

26.2 INTRODUCTION

Few Countries have a complex a structure for their central bank as the U.S in the Federal Reserve System. The Federal Reserve System was shaped the same political struggle that gave the U.S a fragmented banking system. The Federal Reserve System is the Central Bank of the U.S. It is unique among the major central banks of the world. Central banks in other countries of the are centralized, where as in U.S with a head office in Washington, there are twelve district central banks and 24 branches. In other countries the central banks are part of the government, where as in U.S it is a independent agency. In this unit you are going to study the structure of the Federal Reserve System which consist of Board of Governors, Federal Reserve Banks and Federal Open Market Committee which are extremely important. Now let us study the evolution of central banking in U.S, their organization and their respective functions.

26.3 EVOLUTION

Soon after the Independence attempts were made to establish central bank both by government and private share holders. Earliest attempt was made in 1791 and First Bank of United State was established. This bank issued limited volume of notes, and acted as fiscal agent for government. The bank worked successfully till 1811 when it could not get its charater extended. Then Second Bank of United States was established in 1816 and was working the same way as the First bank. But due to political reasons this bank closed its business in 1836. Abolition of the Second Bank of the U.S left the nation without an official lender of last resort for banks. This gap was filled by private institutions. But the severe nationwide financial panic from 1873 to 1907 raised the fears in congress that the U.S.financial system was untable and called for government intervention. Government appointed a National Monetary Commission to design a central bank for the country. Government finally passed the Federal Reserve Act in 1913 and created the Federal

Reserve System. But the Federal Reserve System was designed not as a single strong central bank, but as a federation of largely autonomous 12 regional central banks. Each regional bank was to be responsible to the needs of the area or of the district.

26.4 STRUCTURE OF FEDERAL RESERVE SYSTEM

The Federal Reserve Act of 1913 created a central bank for U.S, the Federal Reserve System. The act provided for checks and balances that were designed to diffuse economic power in three ways: among bankers and business interest, among states and regions and between government and private sector. The Federal Reserve System was designed not as a single strong central bank, but as a federation of largely autonomous regional central banks. Each regional bank was to be responsive to the unique needs of its area. The act and legislation subsequently created four groups within the system, each empowered to perform separate duties. They are Board of Governors, Federal Reserve Banks, Federal Open Market Committee and Member banks. Now let us study the roles of these groups in detail.

26.5 BOARD OF GOVERNORS

The Central controlling authority in the Federal Reserve System is the Board of Governors. It is located at Washington. It consist of 7 members appointed by the President for a period of 14 years with the approval of the U.S sentate. To provide for central bank independence the members are appointed for long period (14 years) and the appointment is neither renewed nor terminated by President. No more than one member can come from each Federal Reserve District. Many board members are professional economist from business, government or academic field. The members of the board are not allowed to resign their office befour the expiry of their term and accept any position with a member bank within two years. The President of U.S selects the chairman and Vice-chairman of the board among the board members; for a term of four years. The Chairman of the Board of Governors advises the President and testifies before congress on economic matters.

26.5.1 Powers of Board of Governors

The powers of the Board of Governors are wide ranging. It administers monetary policy to influence the nations money supply through open market operations, reserve requirements and discount rate. Since 1935, it has the authority to determine reserve requirements within the limit set by congress. It also effectively sets the discount rate through its review and determination procedure. It hold seven of twelve seats on the Federal Open Market Committee and influences the setting of guidelines for open market operations. It informally influences the national and international economic policy decisions.

On the administration actions, it has to power to admit state banks to be the members of Federal Reserve System. It appoints Federal Reserve Banks directors. It has the power to revise various regulations. In respect of bank examination and supervision it is empowered to examine books and affairs of Federal Reserve banks at least once in a year and in case of member banks twice in a year. It has also to publish a weekly statement showing the position of each Federal Reserve Bank as regards assets and liabilities. It has the power to regulate maximum interest rates on time deposits and reserves or member banks. It is empowered to suspend the reserve requirements for member banks and the Federal Reserve Banks for a limited periods in times of emergency, suspend or remove the officers and director of any member bank which continues to violate the law or indulging in unsound banking practices after being warned.

26.6 FEDERAL RESERVE BANKS

For administrative purpose the Federal Reserve Act divided U.S into 12 Federal Reserve Districts, each to which has a Federal Reserve Bank to conduct discount lending. No state is a single Federal Reserve Districts. Most Federal Reserve Districts contain a mixture of urban and rural areas, as well as industry and agriculture and service business interest. This arrangement is to prevent any one interest group or one state from obtaining preferential treatment from the district Federal Reserve Bank. Some district banks have established a total number of 24 branches for administrative purposes. Although the Federal Reserve Banks had a good deal of autonomous decision making authority, for the most part of this power was transferred to the Board of Governors by the Banking Act of 1935. The Federal Reserve Banks are subordinate to the Board of Governors, their purpose is to carry out Board decisions at the regional level.

26.6.1 Structure and Capital

Each Federal Reserve Bank has nine members board of directors. Six of the nine are elected by the member banks of the district. Out this three must be bankers and other three must have no banking connections. Board of Governors appoints the other three members and are supposed to represent interest of public. The chief administrative officer of each Federal Reserve Bank is its President and he is responsible for its day to day operation and for carrying out the decisions of Board of Governors.

The capital stock of each Federal Reserve Bank is divided into shares of 100 dollors each and the minimum is 40,00,000 dollors. Every National Bank was required to become a member of the Federal Reserve System by subscribing to the capital stock an amount equal to 6% of its stock and capital. In principle, the private commercial banks in each district are the members of Federal Reserve System own the district bank. In fact, each Federal Reserve Bank is a private government joint venture. Member banks receive divideds of 6% on the shares of stock.

26.6.2 Functions

The functions of Federal Reserve Banks are as follows :

1. Supervision, examination and regulation of member banks:- The Federal Reserve Banks examine the state chartered member bank regularly.
2. Each member bank is required to maintain reserves in the form of vault cash and deposits at its district Federal Reserve Banks. These reserves are used
   (a) in creation of reserves for member banks. The member banks borrow from their district bank to meet temporary shortage of reserves against collateral. When it lends reserves, the Federal Reserve Bank simply increases the member banks deposit balance.
   (b) Member bank reserve deposit account one mechanism through which the economy is supplied with currency. By reducing the demand deposit liability and vault cash it increases the supply of currency.
   (c) Through federal fund market, commercial banks lend their excers funds in reserves to other banks with a shortage of reserves.
   (d) Many cheques are cleared and collected through member

bank reserves accounts.

3. The nation wide clearing and processing of cheques was one of the principal functions the Federal Reserve Bank was designed to perform under Federal Reserve Act and it has been quite successful in fulfilling this task. Here reciprocal amounts of cheques are offset against one another or cleared and only net differences are paid or collected.
4. Federal Reserve Bank serve as the fiscal agent for U.S Treasury and advises on a wide variety of financial matters. It clears and collect cheques for Treasury and assist in public debt transactions.
5. The Federal Reserve Banks conducts programme of economic research on financial matters and monetary policy, collects data and surveys are made each year. These data are analysed both for the purposes of current economic intelligence and for more basic research purposes.
6. Federal Reserve Banks are allowed to have direct dealings with individuals or business houses. They may make loans to established industries or commercial firms for a period of not exceeding five years.

26.6.3 Issue of Federal Reserve Notes

Under Federal Reserve System a Federal Reserve Bank has to make an application to the local Federal Reserve Agent for the required amount of Federal Reserve notes. The Board of Governors has the power to grant or reject such application. Proper securities should be offered in form of gold or gold certificates, drafts and bills of exchange. The Federal Reserve Agent is required to notify the Board of Governors every day of all issues and withdrawals of Federal Reserve notes by the Federal Reserve Bank to which he is attached. Every Federal Reserve Bank is required to maintain in gold or gold certificates of not less than 25% against its deposit and note liability. With a view to introduce elasticity in the note issue system a provision has been in the Act to suspend the reserve requirements for the temporary period. With the permission of Board of Governors, Banks are allowded the resources to fall below the legal minimum for 30 days and a tax will levied on the amount of the short fall in the reserve.

26.6.4 Credit Control

The Federal Reserve Banks uses both quantitative and qualitative methods to control credit. The quantitative credit method includes bank rate or discount rate policy, open market operation and varying cash reserves requirements. In addition to its general or quantitative credit controls the Federal Banks possesses the authority to vary by administrative action called qualitative or selective credit control instruments. We shall briefly discuss these instruments of credit control.

1. Bank rate or Discount Policy

Discount policy includes setting the discount rate and terms of discount, is the oldest of the Federal Reserve Banks tools for regulating the money supply. Discount rate is the 'price' that a district Federal Bank charges member banks who borrow reserves. Such borrowing is generally for a short period of time ranging from 15 to 90 days. Every district Federal Reserve Bank sets its own discount rate, but decision is subject to review by the Board of Governors. Thus the discount rate reflect the regional money market conditions and they need not move in the same degree for all the Federal Reserve Banks. Although rate changes do not occurs frequently, rates are reviewed by the Federal Reserve Bank every 14 days. An increase in the volume of discount loans raises monetary base and the money supply, whereas decrease in the volume of discount loans reduces the monetary base and the money supply. When changes are announced, the new rates are usually the same among the various Federal Reserve Banks. This tendency has become more prounced in recent years as various sections of the nation have lost their regional character and in financial matters, they have become part of the national money market.

Before 1980 the Federal Reserve Banks use to provide discount loans only to member banks of the Federal Reserve Banks. But since 1980, all depository institutions are having an access to the discount window. For a long time the Federal Reserve Banks has taken the position that discounting is a privilege, not a right of member banks. In other words the bank is a under no obligation to lend to a member bank simply because that bank is willing to pay the current discount rate. The Federal Bank influences the volume of discount loans in two ways. (1) discounting privilege to be used only as a last resort (2) it sets conditions for availability of loans.

Generally the Federal Reserve Banks does not use discount policy as its principal tool for influencing the money supply because (1) changing discount policy will be effective only when the banks accept discount loan. (2) It causes unintended increase or decrease in the monetary base and money supply.

2.Open Market Operation

The purchase and sale of government securities by the Federal Reserve Banks is known as open market operations. It is the most fundamental of all the monetary tools available to Federal Reserve Banks. Purchase of securities increases the monetary base (generally by increasing bank reserves) and sale of securities decreases the monetary base. The Original Federal Reserve Act did not specifically mention open market operations, because they were not well understood in financial markets at that time. Before 1935 districts Federal Reserve Banks conducted limited open market operations in security market. The lack of concerted intervention by the Federal Reserve Banks during the banking crisis of the early 1930s led the congress to establish the Federal Open Market Committee (1933) we shall discuss about this committee in the next section 26.7. The Federal Reserve Banks generally conducts open market operation in liquid Treasury securities markets, affecting interest rates in those markets. Open market purchases tend to reduce interest rates and so are viewed as expansionary. Open market sales tend to increase interest rates and so are viewed as contradictory.

Open market operations have several benefits composed to other tools because (1) It controls their volume of reserves along with influencing the change in monetary base. (2) It is flexible in the sense that back can make both large scale and small scale open market operations according the needs of the economy. Reversing open market operation is simple and quick. It is done through purchase of securities. But it is more difficult to reverse quickly in case of discount policy. (3) Open market operation can be implemented rapidly with no administrative delays. Changing discount rate is lengthier deliberation.

3.Varying Reserve Requirements

The original purpose of varying reserve requirement was to protect depositors by ensuring some minimum level of bank liquidity. But now it is regarded as a monetary tool. As per the Banking Act of 1935 it is compulsory for the banks keep a certain fraction of their deposit in cash or deposits with Federal Reserve Bank. The Board of Governor's has the authority to change reserve requirements within the specified limit granted by congress in the Banking Act of 1935.

Historically reserve requirements varied geographically, member banks in large cities being required to hold more reserves relative to there deposits than the banks in smaller cities and towns. This difference dates back to 1864, following the passage of the National Banking Act of 1863. Between 1966 and 1972, the Federal Reserve Banks altered reserve requirements to reflect the size as well as location of depository institutions. In 1980, the Depository Institutions Deregulation and Monetary Control Act established uniform reserve requirements for all depository institutions, regardless of location.

Federal Banks changes reserve requirements much more rarely than it conducts open market operations or changes the discount rate. Because changes in reserve requirements require significant alterations in banks portfolios, frequent changes would be disruptive. As a result in the 30 years between 1950 to 1980 the Federal Banks adjusted required reserve ratios gradually (about once a year) and followed changes by a open market operations or discount lending to help banks to adjust. In 1996 the reserve requirements on checkable deposits was 3% on the first 52 million and 10% on those in excess of 52 million dollors. Where as it was 10% in 1992. But this policy has been criticised on the ground that it is costly monetary policy. Reserve earn no interest and places a tax on bank intermediation. Secondly, large increases in reserve requirements can adversely affect the economy. Because it reduces bank lending, which decreases credit availability and the money supply.

4. Selective Credit Controls

General monetary controls are designed to affect the reserve position of member banks. Selective credit controls affect the flow of funds between financial institutions, non -financial business and individuals. Some selective credit controls regulate the interest rates payable on various types of time deposits, other regulate the terms on which funds may be borrowed for specific purposes. These controls are based on the presumption that certain types of spending are more important sources of economic instability than others. Let us study some important selective credit controls employed by Federal Reserve Banks.

1. The use of **Regulation Q** enables the Federal Reserve system to set the maximum rate of interest payable by member banks on various classes of time deposits. Federal system uses this monetary control to keep the rates paid by member banks in line with yields on other types of near monies, in order to install excessive interest rate competition

among financial institutions for consumer types time deposits.

2. The Federal Reserve system has the authority to set minimum **margin requirements** on the purchase of stock. A margin requirement is the down payment a purchaser of stock must pay to buy the stock on credit. For example to by a stock worth of Rs.10,000/- if the margin requirement is 70%, then the borrow the Rs.3000 loan. The Rs.10,000 worth of stock is then used as collateral against the loan of Rs.3000/ - This applies to all lenders, securities brokers, commercial banks and others- including member banks.
3. **Real estate credit** controls refer to borrowing for residential construction. This can be controlled by varring the down payment, manupulation of interest rates, time allowed for repayment. This types of credit control was imposed for the first time during the Korean conflict.
4. **Consumer credit** controls are usually designed to regulate spending on consumer durable goods because consumer spending tends to fluctuate with business cycle. Normally the purchase of such consumer durables like refrigerators, washing machines. Television, cars etc., increases during the upward part of the business cycle and decreases during downward part. This type of credit controls were imposed in World War II, between 1948-49 and during Korean war to relieve the inflationary pressure of increased expenditure on consumer durables. This was controlled through fixing minimum down payment, fixing number of installments, types goods etc., One of the difficulties with consumer credit controls was the enforcement, because the number of business establishments and the variety of goods covered was enormous.
5. **Moral suasion** is another type of selective credit control used by Federal Reserve system. It refer to general term describing a variety of informal and non legal methods used by the Federal Reserve System to persuade its member banks to behave in a particular manner. It include speeches given by members of Board of Governors, letter sent to member banks, voluntary programmes of credit restraints, conferences, guidelines etc., The objectives of moral suasion is to restrain the growth of credit going to particular sector of the market. The effectiveness of this instrument depends on the method used, the objective and the period of time under consideration.

26.7 FEDERAL OPEN MARKET COMMITTEE

The lack of concerted intervention by the Federal Reserve System during the banking crisis of the early 1930s lead to the establishment of Federal Open Market Committee (FOMC). The Banking Act of 1933 created FOMC to co-ordinate the open market operations of individual Federal Reserve Banks. FOMC decides for the Federal Reserve System how many government securities to buy or sell in open market. These decisions directly affect the reserve base of commercial banking system and this influences the quantity of money in the country.

The FOMC consists of 12 members. Of these 7 are the members of Board of Governors and the remaining 5 are presidents of the 12 Federal Reserve Banks. The open market policies are executed through the Federal Reserve Bank of New York. Hence the president of this bank is always a member of the committee and the other four president memberships of FOMC are rotated annually among the other 11 Federal Reserve Banks. The chairman of FOMC is the chairman of the Board of Governors. The president of Federal Reserve Bank of New York is vice chairman. Although only five Federal Reserve Bank presidents are the members of FOMC, in practice all the 12 presidents attend committee meetings.

The FOMC meets eight times in a year for the purpose of purchase and sale of securities principally U.S government securities on the open market. Open market transactions in government securities by the Federal Reserve Banks strongly influence the reserve position of the commercial banking system and thus, are important instrument of control over the money supply. FOMC also directs the purchase and sale of foreign currencies by Federal Reserve Banks.

The FOMC is a policy setting organisation and does not itself execute the policy. The Federal Reserve Systems account manager (vice president of the Federal Reserve Bank of New York) is responsible for carrying out open market operation. The Open Market Trading Desk, a group of traders at the Federal Reserve Bank of New York trades government securities over the counter electronically with primary dealers. Before making transaction, the trading desk notifies all the dealers, ask them to submit offers and gives them a deadline. The Federal Reserve Systems account manager goes over the list and accept the best offer. One way the account manager conducts open market operations is through out right purchases and sales of Treasury securities of various maturities by trading desk. Special Manager in foreign currency at the Federal Reserve Bank of New York who will be indulging in buying and selling foreign currencies will be observing the effects of this on

U.S. balance of payments situation. Thus the account manager and special manager have a great deal of responsible in executing the FOMC policies.

26.8 MEMBER BANKS

The last and most numerous component of Federal Reserve System is member banks. Member banks are private, profit seeking corporations which like all commercial banks, possess the ability to create and distroy money in the process of making loans and investments. Federal Reserve Act required all National Banks to become member banks of Federal Reserve System. State Banks can also become if they wish. But currently only about one in seven State Banks is a member. 40% of all banks in U.S belongs to the Federal Reserve System and account for 80% of bank demand deposit liabilities. These banks are, of course, are the most important element of the Federal Reserve System since it is through regulating the financial position of member banks that the Federal Reserve Board attempts to stabilize economic conditions in U.S.

26.9 LET US SUM UP

Soon after the Independence attempts were made to establish central bank at national level for the purpose of discounting bills and to function as lender of last resort. In 1811 and in 1836 these attempts failed. From 1873 to 1907 the financial system was unstable and there was financial panic throughout the nation. National Monetary Commission recommended a federation of largely autonomous 12 regional Central Banks. Federal Reserve Act of 1913 created Federal Reserve System. To diffuse economic power it created separate bodies to perform separate duties. They are Board of Governor, Federal Reserve Banks, Federal Open Market Committee and member banks. Thus the Federal Reserve System has been designed not as a single strong central bank, but as a federation of largely autonomous regional central banks.

26.10 BOOKS FOR SELF STUDY

1. J.N.Mongia	-	Banking Around the World
2. Robin Pringle	-	Banking in Britain
3. Kettel	-	Monetary Economics
4. K.C.Shekhar	-	Banking Theory and Practice

26.11 QUESTION FOR SELF STUDY

1. Explain the structure of Federal Reserve System

2. Discuss the structure and functions of Board of Governors
3. Explain the instruments of credit controls employed by Federal Reserve Banks
4. Discuss the structure and functions of Federal Reserve Banks
5. Write a note on
    (1) Federal Open Market Committee
    (2) Issue of Federal Reserve Notes

NOTES

UNIT 27: NEW YORK MONEY MARKET

Structure

27.1 OBJECTIVES

This unit is going to help you in understanding the U.S.Money market, sub markets in the money market, the credit instruments dealt in these markets.

27.2 INTRODUCTION

The money market is a market for short term loans. Generally this market help the business firms, sales finance companies to finance consumer credit, government to meet temporary shortages in money. Money market is a not a place, but an activity, activity being lending and borrowing money for short term. New York money market is one of the highly developed money market. Though there are money markets in all large cities, the national money market for U.S is New York money market, where billions of dollars are traded daily by buyers and sellrs located throughout the world. There are many kinds of credit instruments dealt in the money market. Hence there is a separate money market for every credit instrument. New York money market is highly mechanized and transaction are carried out by telephone on online between the people without meeting each other. In this unit let us examine the activities carried on in each sub money market.

27.3 TREASURY BILL MARKET

Treasury bills are obligations of U.S. government and are of very high quality. They are issued weekly and carry maturities ranging from three month to one year. These bills do not carry interest rate but are sold on discount basis through action or bidding. Largest volume business is done in this market compared to other money markets. The profit will be the difference between the bidding price and the face value of the treasury bill.

27.4 BANKERS ACCEPTANCE MARKET

It is a old form of commercials credit. Bankers acceptance is a method when by a bank add its good name and reputation to the promissory note of a borrower. Business firms or corporation whenever they are in need of short term funds, they make use of this facility. For example a corporation is need of short to pay certain sum of money to the holder of the draft at some future date. The corporation then takes the draft to the bank and the bank stamps accepted across the face of it. Now it become the responsibility of that bank to pay when it becomes due. Now this draft becomes negotiable, marketable debt instrument and may change from person to person. When the due date arrives, the draft is presented to the bank for payment. Here the bank simply takes money out of corporation account and pays it the holder of bank draft. For the service rendered the bank charges a fee. This market is small as compared to the other markets but it has grown steadily in the past few year.

27.5 COMMERCIAL PAPER MARKET

Commercial paper market is special type of market in the New York money market and this type of market is not seen in other money markets. Commercial paper is nothing but promissory notes of large corporation or of big industrial houses. These are well know in U.S. for their credit worthiness. To meet some urgent expenditure or for their working capital these corporation borrow from the public by selling these promissory notes. These promissory notes or commercial papers generally carries a maturity of from four to six months. It carries interest rates. These commercial papers can be brought and sold in the organised market. Generally the commercial banks are the major buyers of these papers. Sometimes sales finance companies, which supply credit for the installment purchases also buys these papers.

27.6 CERTIFICATES OF DEPOSITS MARKET

The development of this market can be traced back to 1960s. The rise in the interest rates in the early 1960s induced large corporation to shift funds out of demand deposits in to short term money market instruments. As a result there was steep fall in the deposits of banks. Therefore some large banks began to issue certificate of deposits a money market instrument of their own to check fall in deposits. Certificate of deposit is a receipt given by a commercial bank for a deposits of funds, which is a negotiable instrument. The holder of the certificate of deposit at maturity will get interest plus capital. These certificate of deposit may not be converted in to cash before it matures. But it may be sold by the buyer in a secondary market. Because of this facility, the volume of these certificate increased to a great extent in 1970s and 1980s.

27.7 FEDERAL FUND MARKET

This is a market consisting of banks only. The buyer and sellers are banks. Federal funds are the balance held in the Federal Reserve System. Every member of Federal Reserve System in required by law to keep certain percentage of their deposits as cash reserve and are held in the form to deposit balances at the district Federal Reserve Bank. If on any day any member bank holds less than the required amount, then the bank will be penalized. Therefore the deficit banks borrow funds from the bank which will have an excess reserve for a day or two. The bank which will be having excess reserves with the Federal Reserve Bank will not earn any interest on excess reserves. So by lending it to other banks it earns profits. Thus the federal funds market is a market where in banks with surplus reserves lend it other banks with low reserves.

27.8 EURODOLLAR MARKET

It refer to dollar deposits in foreign commercial banks and in foreign branches of U.S. banks. The deposits are held in terms of dollars rather than in the monetary unit of the country. For example the foreign bank of U.S. in England hold deposits in terms of dollars rather than pounds. Euro dollars are lend and borrowed freely at market determined rates of interest. Though England is the center of Euro dollar activity, this activity can be seen in all major financial cities of the world. In U.S. only a few banks are active in this market.

27.9 LET US SUM UP

New York money market is one of the important market in the world. It is a well developed and organised money market. This market consist of sub markets like Treasury Bills market. Banker's Acceptance market, commercial paper market, Federal Fund market and Euro dollar market. These sub market specialized in trading one particular type of credit instrument.

27.10 BOOKS FOR SELF STUDY

1. Money and the Economy	-	John J. Klein
2. Money and Banking	-	Dudley G. Luckett
3. Banking Theory and Practice	-	K.S. Shekhar
4. Money the Financial System and the Economy	-	R. Glenn Hubbard
5. Economics of Money and Banking	-	Chandler L.V

27.11 QUESTION FOR SELF STUDY

Explain the structure of New York money market.

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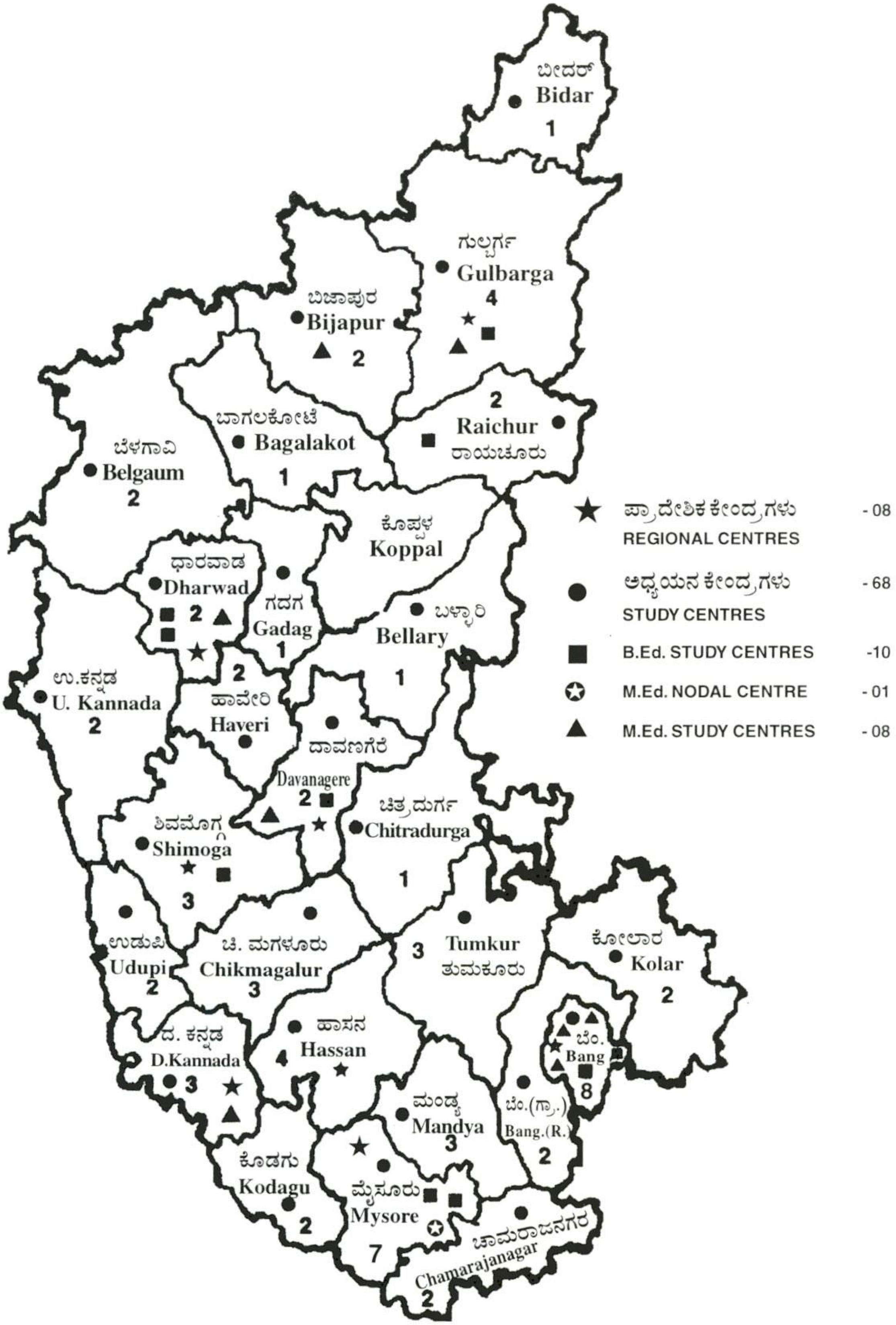
ಆದೇಶ ಸಂಖ್ಯೆ : ಕರಾಮುವಿ/ಸಿಪಾವಿ / 4/520/2006-2007 ದಿನಾಂಕ : 05-09-2006
ಒಳಪುಟ : 60 GSM MPM ವೈಟ್ ಪ್ರಿಂಟಿಂಗ್ ಪೇಪರ್ ಮತ್ತು ಹೊರಪುಟ : 170 GSM ಆರ್ಟ್‌ಕಾರ್ಡ್
ಮುದ್ರಕರು : ಪೂರ್ಣಿಮ ಪ್ರಿಂಟರ್ಸ್, ಬೆಂಗಳೂರು - 560 040. ಪ್ರತಿಗಳು : 1000, ಮುದ್ರಿಸಿದ ದಿನಾಂಕ : 07-09-2006

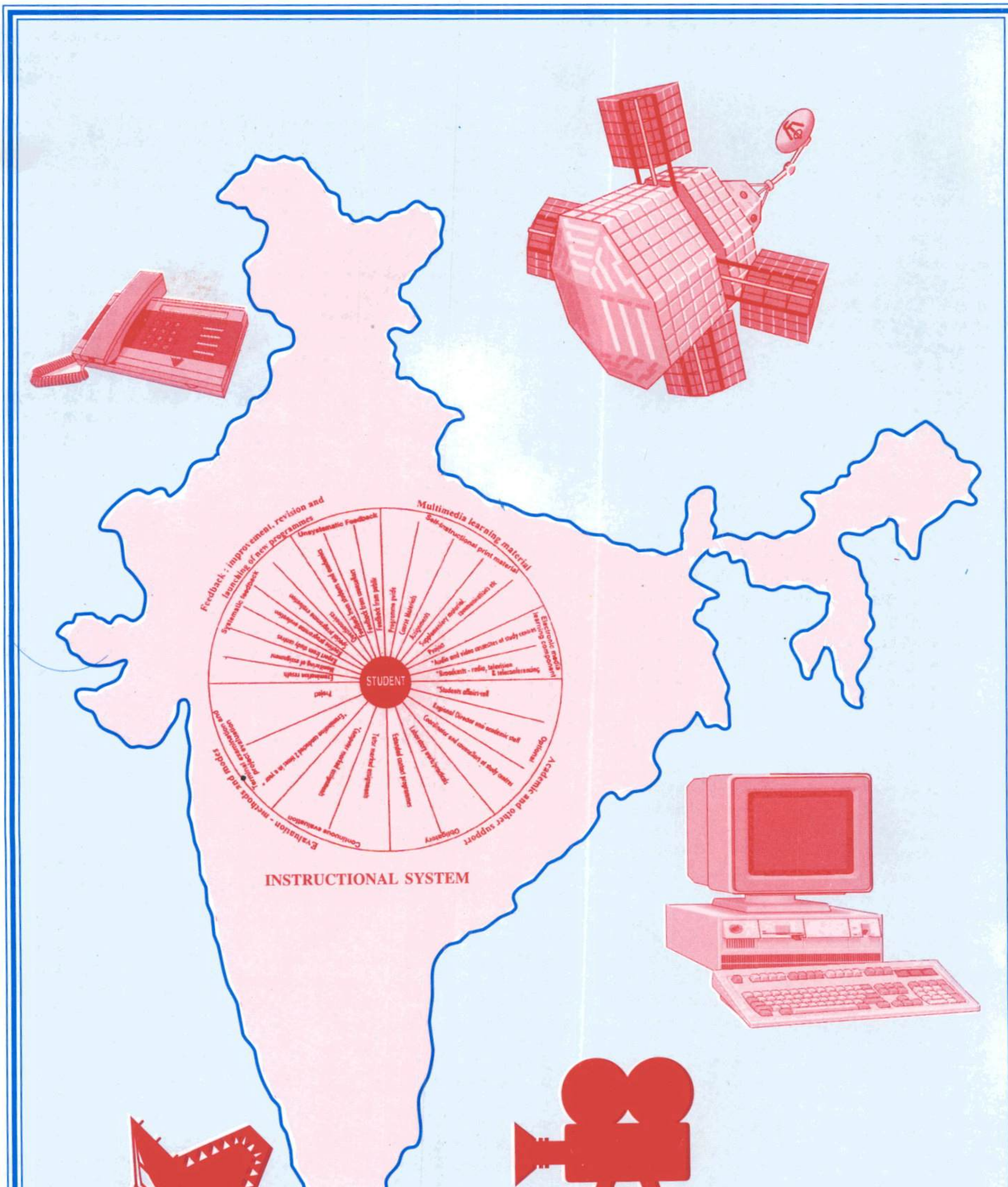
ಕರ್ನಾಟಕ ರಾಜ್ಯ ಮುಕ್ತ ವಿಶ್ವವಿದ್ಯಾನಿಲಯದ ಪ್ರಾದೇಶಿಕ ಹಾಗೂ ಅಧ್ಯಯನ ಕೇಂದ್ರಗಳು

Regional and Study Centres of Karnataka State Open University



(ನಮೂದಿಸಿರುವ ಅಂಕಿ - ಜಿಲ್ಲೆಯಲ್ಲಿರುವ ಒಟ್ಟು ಅಧ್ಯಯನ ಕೇಂದ್ರಗಳ ಸಂಖ್ಯೆಯನ್ನು ಸೂಚಿಸುತ್ತದೆ.)

The Number Indicate the Total Number of Study Centres Existing in that Districts.


Multimedia learning material
Academic and other support
Evaluation - methods and modes
Feedback : improvement, revision and launching of new programmes
STUDENT
INSTRUCTIONAL SYSTEM