TYBBI
CENTRAL BANKING

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MODULE 1 : AN OVERVIEW OF CENTRAL BANKING
Overview: Concept and Institutional Growth of Central Banking,
The Changing Face of Central Banking.
Role of Central Banks: Determination of Goals, Inflation Targeting, Exchange Rate Targeting, Money Supply Targeting, Money Growth Targeting, Viable Alternatives to Central Bank, Central Banking in India.
Contemporary Issues, Autonomy and Independence, Credibility, Accountability and Transparency of a Central Bank.

MODULE 1 : AN OVERVIEW OF CENTRAL BANKING

A BRIEF HISTORY OF CENTRAL BANKS

A central bank is the term used to describe the authority responsible for policies that affect a country's supply of money and credit. More specifically, a central bank uses its tools of monetary policy—open market operations, discount window lending, changes in reserve requirements—to affect short-term interest rates and the monetary base (currency held by the public plus bank reserves) and to achieve important policy goals.

One of the world's foremost economic historians explains the forces behind the development of modern central banks, providing insight into their role in the financial system and the economy.
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There are three key goals of modern monetary policy. The first and most important is price stability or stability in the value of money. Today this means maintaining a sustained low rate of inflation. The second goal is a stable real economy, often interpreted as high employment and high and sustainable economic growth. Another way to put it is to say that monetary policy is expected to smooth the business cycle and offset shocks to the economy. The third goal is financial stability. This encompasses an efficient and smoothly running payments system and the prevention of financial crises.

Beginnings

The story of central banking goes back at least to the seventeenth century, to the founding of the first institution recognized as a central bank, the Swedish Riksbank. Established in 1668 as a joint stock bank, it was chartered to lend the government funds and to act as a clearing house for commerce. A few decades later (1694), the most famous central bank of the era, the Bank of England, was founded also as a joint stock company to purchase government debt. Other central banks were set up later in Europe for similar purposes, though some were established to deal with monetary disarray. For example, the Banque de France was established by Napoleon in 1800 to stabilize the currency after the hyperinflation of paper money during the French Revolution, as well as to aid in government finance. Early central banks issued private notes which served as currency, and they often had a monopoly over such note issue.
While these early central banks helped fund the government's debt, they were also private entities that engaged in banking activities. Because they held the deposits of other banks, they came to serve as banks for bankers, facilitating transactions between banks or providing other banking services. They became the repository for most banks in the banking system because of their large reserves and extensive networks of correspondent banks. These factors allowed them to become the lender of last resort in the face of a financial crisis. In other words, they became willing to provide emergency cash to their correspondents in times of financial distress.

Transition

The Federal Reserve System belongs to a later wave of central banks, which emerged at the turn of the twentieth century. These banks were created primarily to consolidate the various instruments that people were using for currency and to provide financial stability. Many also were created to manage the gold standard, to which most countries adhered.
The gold standard, which prevailed until 1914, meant that each country defined its currency in terms of a fixed weight of gold. Central banks held large gold reserves to ensure that their notes could be converted into gold, as was required by their charters. When their reserves declined because of a balance of payments deficit or adverse domestic circumstances, they would raise their discount rates (the interest rates at which they would lend money to the other banks). Doing so would raise interest rates more generally, which in turn attracted foreign investment, thereby bringing more gold into the country.

Central banks adhered to the gold standard's rule of maintaining gold convertibility above all other considerations. Gold convertibility served as the economy's nominal anchor. That is, the amount of money banks could supply was constrained by the value of the gold they held in reserve, and this in turn determined the prevailing price level. And because the price level was tied to a known commodity whose long-run value was determined by market forces, expectations about the future price level were tied to it as well. In a sense, early central banks were strongly committed to price stability. They did not worry too much about one of the modern goals of central banking—the stability of the real economy—because they were constrained by their obligation to adhere to the gold standard.

Central banks of this era also learned to act as lenders of last resort in times of financial stress—when events like bad harvests, defaults by railroads, or wars precipitated a scramble for liquidity (in which depositors ran to their banks and tried to convert their deposits into cash). The lesson began early in the nineteenth century as a consequence of the Bank of England's routine response to such panics. At the time, the Bank (and other European central banks) would often protect their own gold reserves first, turning away their correspondents in need. Doing so precipitated major panics in 1825, 1837, 1847, and 1857, and led to severe criticism of the Bank. In response, the Bank adopted the "responsibility doctrine," proposed by the economic writer Walter Bagehot, which required the Bank to subsume its private interest to the public interest of the banking system as a whole. The Bank began to follow Bagehot's rule, which was to lend freely on the basis of any sound collateral offered—but at a penalty rate (that is, above market rates) to prevent moral hazard. The bank learned its lesson well. No financial crises occurred in England for nearly 150 years after 1866. It wasn't until August 2007 that the country experienced its next crisis.

The U.S. experience was most interesting. It had two central banks in the early nineteenth century, the Bank of the United States (1791–1811) and a second Bank of the United States (1816–1836). Both were set up on the model of the Bank of England, but unlike the British, Americans bore a deep-seated distrust of any concentration of financial power in general, and of central banks in particular, so that in each case, the charters were not renewed.
There followed an 80-year period characterized by considerable financial instability. Between 1836 and the onset of the Civil War—a period known as the Free Banking Era—states allowed virtual free entry into banking with minimal regulation. Throughout the period, banks failed frequently, and several banking panics occurred. The payments system was notoriously

inefficient, with thousands of dissimilar-looking state bank notes and counterfeits in circulation. In response, the government created the national banking system during the Civil War. While the system improved the efficiency of the payments system by providing a uniform currency based on national bank notes, it still provided no lender of last resort, and the era was rife with severe banking panics.

The crisis of 1907 was the straw that broke the camel's back. It led to the creation of the Federal Reserve in 1913, which was given the mandate of providing a uniform and elastic currency (that is, one which would accommodate the seasonal, cyclical, and secular movements in the economy) and to serve as a lender of last resort.

The Genesis of Modern Central Banking Goals

Before 1914, central banks didn't attach great weight to the goal of maintaining the domestic economy's stability. This changed after World War I, when they began to be concerned about employment, real activity, and the price level. The shift reflected a change in the political economy of many countries—suffrage was expanding, labor movements were rising, and restrictions on migration were being set. In the 1920s, the Fed began focusing on both external stability (which meant keeping an eye on gold reserves, because the U.S. was still on the gold standard) and internal stability (which meant keeping an eye on prices, output, and employment). But as long as the gold standard prevailed, external goals dominated.
Unfortunately, the Fed's monetary policy led to serious problems in the 1920s and 1930s. When it came to managing the nation's quantity of money, the Fed followed a principle called the real bills doctrine. The doctrine argued that the quantity of money needed in the economy would naturally be supplied so long as Reserve Banks lent funds only when banks presented eligible self-liquidating commercial paper for collateral. One corollary of the real bills doctrine was that the Fed should not permit bank lending to finance stock market speculation, which explains why it followed a tight policy in 1928 to offset the Wall Street boom. The policy led to the beginning of recession in August 1929 and the crash in October. Then, in the face of a series of banking panics between 1930 and 1933, the Fed failed to act as a lender of last resort. As a result, the money supply collapsed, and massive deflation and depression followed. The Fed erred because the real bills doctrine led it to interpret the prevailing low short-term nominal interest rates as a sign of monetary ease, and they believed no banks needed funds because very few member banks came to the discount window.

After the Great Depression, the Federal Reserve System was reorganized. The Banking Acts of 1933 and 1935 shifted power definitively from the Reserve Banks to the Board of Governors. In addition, the Fed was made subservient to the Treasury.

The Fed regained its independence from the Treasury in 1951, whereupon it began following a deliberate countercyclical policy under the directorship of William McChesney Martin. During the 1950s this policy was quite successful in ameliorating several recessions and in maintaining low inflation. At the time, the United States and the other advanced countries were part of the Bretton Woods System, under which the U.S. pegged the dollar to gold at $35 per ounce and the other countries pegged to the dollar. The link to gold may have carried over some of the credibility of a nominal anchor and helped to keep inflation low.

The picture changed dramatically in the 1960s when the Fed began following a more activist stabilization policy. In this decade it shifted its priorities from low inflation toward high employment. Possible reasons include the adoption of Keynesian ideas and the belief in the Phillips curve trade-off between inflation and unemployment. The consequence of the shift in policy was the buildup of inflationary pressures from the late 1960s until the end of the 1970s. The causes of the Great Inflation are still being debated, but the era is renowned as one of the low points in Fed history. The restraining influence of the nominal anchor disappeared, and for the next two decades, inflation expectations took off.

The inflation ended with Paul Volcker's shock therapy from 1979 to 1982, which involved monetary tightening and the raising of policy interest rates to double digits. The Volcker shock led to a sharp recession, but it was successful in breaking the back of high inflation expectations. In the following decades, inflation declined significantly and has stayed low ever since. Since the early 1990s the Fed has followed a policy of implicit inflation targeting, using the federal funds rate as its policy instrument. In many respects, the policy regime currently followed echoes the convertibility principle of the gold standard, in the sense that the public has come to believe in the credibility of the Fed's commitment to low inflation.

A key force in the history of central banking has been central bank independence. The original central banks were private and independent. They depended on the government to maintain their charters but were otherwise free to choose their own tools and policies. Their goals were constrained by gold convertibility. In the twentieth century, most of these central banks were nationalized and completely lost their independence. Their policies were dictated by the fiscal authorities. The Fed regained its independence after 1951, but its independence is not absolute. It must report to Congress, which ultimately has the power to change the Federal Reserve Act. Other central banks had to wait until the 1990s to regain their independence.

Financial Stability

An increasingly important role for central banks is financial stability. The evolution of this responsibility has been similar across the advanced countries. In the gold standard era, central banks developed a lender-of-last-resort function, following Bagehot's rule. But financial systems became unstable between the world wars, as widespread banking crises plagued the early 1920s and the 1930s. The experience of the Fed was the worst. The response to banking crises in Europe at the time was generally to bail out the troubled banks with public funds. This approach was later adopted by the United States with the Reconstruction Finance Corporation, but on a limited scale. After the Depression, every country established a financial safety net, comprising deposit insurance and heavy regulation that included interest rate ceilings and firewalls between financial and commercial institutions. As a result, there were no banking crises from the late 1930s until the mid-1970s anywhere in the advanced world.

This changed dramatically in the 1970s. The Great Inflation undermined interest rate ceilings and inspired financial innovations designed to circumvent the ceilings and other restrictions. These innovations led to deregulation and increased competition. Banking instability reemerged in the United States and abroad, with such examples of large-scale financial disturbances as the failures of Franklin National in 1974 and Continental Illinois in 1984 and the savings and loan crisis in the 1980s. The reaction to these disturbances was to bail out banks considered too big to fail, a

reaction which likely increased the possibility of moral hazard. Many of these issues were resolved by the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Basel I Accords, which emphasized the holding of bank capital as a way to encourage prudent behavior.

Another problem that has reemerged in modern times is that of asset booms and busts. Stock market and housing booms are often associated with the business cycle boom phase, and busts often trigger economic downturns. Orthodox central bank policy is to not defuse booms before they turn to busts for fear of triggering a recession but to react after the bust occurs and to supply ample liquidity to protect the payments and banking systems. This was the policy followed by Alan Greenspan after the stock market crash of 1987. It was also the policy followed later in the incipient financial crises of the 1990s and 2000s. Ideally, the policies should remove the excess liquidity once the threat of crisis has passed.

Challenges for the Future

The key challenge I see facing central banks in the future will be to balance their three policy goals. The primary goal of the central bank is to provide price stability (currently viewed as low inflation over a long-run period). This goal requires credibility to work. In other words, people need to believe that the central bank will tighten its policy if inflation threatens. This belief needs to be backed by actions. Such was the case in the mid-1990s when the Fed tightened in response to an inflation scare. Such a strategy can be greatly enhanced by good communication.
The second policy goal is stability and growth of the real economy. Considerable evidence suggests that low inflation is associated with better growth and overall macroeconomic performance. Nevertheless, big shocks still occur, threatening to derail the economy from its growth path. When such situations threaten, research also suggests that the central bank should temporarily depart from its long-run inflation goal and ease monetary policy to offset recessionary forces. Moreover, if market agents believe in the long-run credibility of the central bank's commitment to low inflation, the cut in policy interest rates will not engender high inflation expectations. Once the recession is avoided or has played its course, the central bank needs to raise rates and return to its low-inflation goal.

The third policy goal is financial stability. Research has shown that it also will be improved in an environment of low inflation, although some economists argue that asset price booms are spawned in such an environment. In the case of an incipient financial crisis such as that just witnessed in August 2007, the current view is that the course of policy should be to provide whatever liquidity is required to allay the fears of the money market. An open discount window and the acceptance of whatever sound collateral is offered are seen as the correct prescription. Moreover, funds should be offered at a penalty rate. The Fed followed these rules in September 2007, although it is unclear whether the funds were provided at a penalty rate. Once the crisis is over, which generally is in a matter of days or weeks, the central bank must remove the excess liquidity and return to its inflation objective.

The Federal Reserve followed this strategy after Y2K. When no financial crisis occurred, it promptly withdrew the massive infusion of liquidity it had provided. By contrast, after providing funds following the attacks of 9/11 and the technology bust of 2001, it permitted the additional funds to remain in the money market once the threat of crisis was over. If the markets had not

been infused with so much liquidity for so long, interest rates would not have been as low in recent years as they have been, and the housing boom might not have as expanded as much as it did.

A second challenge related to the first is for the central bank to keep abreast of financial innovations, which can derail financial stability. Innovations in the financial markets are a challenge to deal with, as they represent attempts to circumvent regulation as well as to reduce transactions costs and enhance leverage. The recent subprime crisis exemplifies the danger, as many problems were caused by derivatives created to package mortgages of dubious quality with sounder ones so the instruments could be unloaded off the balance sheets of commercial and investment banks. This strategy, designed to dissipate risk, may have backfired because of the opacity of the new instruments.

A third challenge facing the Federal Reserve in particular is whether to adopt an explicit inflation targeting objective like the Bank of England, the Bank of Canada, and other central banks. The advantages of doing so are that it simplifies policy and makes it more transparent, which eases communication with the public and enhances credibility. However, it might be difficult to combine an explicit target with the Fed's dual mandate of price stability and high employment. A fourth challenge for all central banks is to account for globalization and other supply-side developments, such as political instability and oil price and other shocks, which are outside of their control but which may affect global and domestic prices.

The final challenge I wish to mention concerns whether implicit or explicit inflation targeting should be replaced with price-level targeting, whereby inflation would be kept at zero percent. Research has shown that a price level may be the superior target, because it avoids the problem of base drift (where inflation is allowed to cumulate), and it also has less long-run price uncertainty. The disadvantage is that recessionary shocks might cause a deflation, where the price level declines. This possibility should not be a problem if the nominal anchor is credible, because the public would realize that inflationary and deflationary episodes are transitory and prices will always revert to their mean, that is, toward stability.

Such a strategy is not likely to be adopted in the near future because central banks are concerned that deflation might get out of control or be associated with recession on account of nominal rigidities. In addition, the transition would involve reducing inflation expectations from the present plateau of about 2 percent, which would likely involve deliberately engineering a recession—a policy not likely to ever be popular.

ROLE/ FUNCTIONS OF CENTRAL BANKS

Banker to the government

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

In addition to being the bank to the government, it acts as an advisor and agent of the government by providing advice to the government in areas of economic policy, capital market, money market and loans from the government.
In addition to that, the central bank is instrumental in formulation of monetary and fiscal policies that help in regulation of money in the market and controlling inflation.

Lender of last resort

The central bank acts as a lender of last resort by providing money to its member banks in times of cash crunch. It performs this function by providing loans against securities, treasury bills and also by rediscounting bills.
This is regarded as one of the most crucial functions of the central bank wherein it helps in protecting the financial structure of the economy from collapsing.

Controller of Credit

Central banks also function as the controller of credit in the economy. It happens that commercial banks create a lot of credit in the economy that increases the inflation.
The central bank controls the way credit creation by commercial banks is done by engaging in open market operations or bringing about a change in the CRR to control the process of credit creation by commercial banks.

Custodian of cash reserves

It is a practice of the commercial banks of a country to keep a part of their cash balances in the form of deposits with the central bank. The commercial banks can draw that balance when the requirement for cash is high and pay back the same when there is less requirement of cash.
It is for this reason that the central bank is regarded as the banker's bank. Central bank also plays an important role in the credit creation policy of commercial banks.

Protecting depositors interests

The Central bank also needs to keep an eye on the functioning of the commercial banks in order to protect the interests of depositors.

Clearing house for transfer and settlement

Central bank acts as a clearing house of the commercial banks and helps in settling of mutual indebtedness of the commercial banks. In a clearing house, the representatives of different banks meet and settle the inter bank payments.

Custodian of International currency

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

Currency regulator or bank of issue

Central banks possess the exclusive right to manufacture notes in an economy. All the central banks across the world are involved in issuing notes to the economy.
This is one of the most important functions of the central bank in an economy and due to this the central bank is also known as the bank of issue.

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

Determination of Goals

INFLATION TARGETING

Inflation targeting is a goals-based approach to monetary policy whereby a central bank seeks a specific annual rate of inflation for a country's economy (normally around 2% or 3% per year). The central bank can then use a range of policy measures, such as setting interest rates or open market operations (OMOs), to maintain that target.

Research suggests that economies become more resilient and prices more stable once inflation targeting has been adopted, although some economists critique the measure as ineffective—for instance, in the decade following the 2008 financial crisis, when inflation remained well below the target rate in many countries for years.5 More recently, inflation has surged above the target rate around the globe in 2022.

How does inflation targeting work?
Inflation targeting is straightforward, at least in theory. The central bank forecasts the future path of inflation and compares it with the target inflation rate (the rate the government believes is appropriate for the economy). The difference between the forecast and the target determines how much monetary policy has to be adjusted. Some countries have chosen inflation targets with symmetrical ranges around a midpoint, while others have identified only a target rate or an upper limit to inflation. Most countries have set their inflation targets in the low single digits. A major advantage of inflation targeting is that it combines elements of both "rules" and "discretion" in monetary policy. This "constrained discretion" framework combines two distinct elements: a precise numerical target for inflation in the medium term and a response to economic shocks in the short term.

Rather than focusing on achieving the target at all times, the approach has emphasized achieving the target over the medium term—typically over a two- to three-year horizon. This allows policy to address other objectives—such as smoothing output—over the short term. Thus, inflation targeting provides a rule-like framework within which the central bank has the discretion to react to shocks. Because of inflation targeting's medium-term focus, policymakers need not feel compelled to do whatever it takes to meet targets on a period-by-period basis.

EXCHANGE RATE TARGETING

This has the aim of protecting the foreign interest of the country within its jurisdiction. In this regard, the central bank plays a crucial role in altering interest rates. An increase in interest rates stimulates traders to buy the respective country's currency.
Exchange Rate and Inflation Targeting: A Comparative Analysis

Exchange Rate Targeting (ERT) and Inflation Targeting (IT) are two of the most prominent monetary policy strategies. Both have their pros and cons and are chosen based on a country's economic priorities and stability.

- ERT: Best suited for smaller and emerging economies with developing financial markets. It's useful to maintain a stable exchange rate and attract foreign investment. However, it can also open the economy to foreign shocks and limit the central bank's ability to respond to domestic conditions.
- IT: Often adopted by more developed economies with deep and liquid financial markets. This approach provides the central bank with more control over domestic monetary conditions. However, it can lead to higher exchange rate volatility.

Impact of Exchange Rate Targeting on Inflation Control

ERT has a significant role in managing inflation. Essentially, targeting a specific exchange rate, especially by pegging a domestic currency to a stable currency like the US dollar or euro, can import price stability. Let's take an example: If a country's currency appreciates (increases in value), the price of imported goods and services drops. This leads to a decrease in general price levels, thus helping control inflation.

Example

Suppose country A decides to apply ERT to appreciate its currency. Now, the previously priced imported product at 100 units of country A’s currency might now cost 80 units. Such a decrease in general price levels can successfully reduce inflation rates.

Contrastingly, it may also limit the ability of the central bank to address domestic inflation independently. It's because maintaining the targeted exchange rate might require actions that conflict with inflation-targeting measures. In other words, ERT could sometimes restrict an independent monetary policy.

Exchange Rate Targeting Methods: Fixed vs Flexible

Exchange Rate Targeting employs distinct methods, vital among them being Fixed and Flexible ERT. Both these methods hold their unique advantages and pose specific challenges, impacting an economy's macroeconomic environment differently.

Fixed Exchange Rate Targeting: The Ups and Downs

When it comes to Exchange Rate Targeting, the fixed approach is a classic and highly effective strategy. In this method, a country's central bank sets a specific value for the currency and then, through market intervention, purchases or sells domestic currency to maintain it at that price. The value is commonly set against a major global currency such as the US Dollar, Euro, or a basket of currencies.

Meaning

Fixed Exchange Rate Targeting (FERT) allows for predictability and stability in foreign trade and investment. This method reduces foreign exchange risk, which is very appealing for international trade and investment. It also discourages speculative attacks as the potential profit from predicting changes in the exchange rate is nullified.

However, FERT is not devoid of shortcomings. These include:

- Susceptibility to global shocks: If the reference currency's value fluctuates considerably due to global economic events, the domestic currency tied to it can also experience volatility.

- Limited monetary policy independence: The central bank's priority becomes maintaining the fixed exchange rate, potentially conflicting with other macroeconomic objectives such as controlling inflation or managing unemployment.
- Significant foreign reserves required: Central banks need vast foreign currency reserves to intervene in foreign exchange markets and maintain the fixed exchange rate.

Implementing and Managing Fixed Exchange Rate Targeting

The implementation and management of Fixed Exchange Rate Targeting necessitate calculated steps and constant vigilance. To implement FERT, a country's central bank declares a specific value for its currency and then commits to maintaining that rate in the foreign exchange market. As demand and supply dynamics shift, the central bank must continuously buy or sell its currency to keep the exchange rate within the desired range.

Meaning

Flexible Exchange Rate Targeting (FERT) equips a country with the freedom of monetary policy. A central bank has more liberty to adjust its monetary policy to domestic economic conditions without worrying about maintaining a specific exchange rate. It also allows for automatic correction of trade imbalances.

But as with all monetary strategies, there are challenges too. These include:

- Potential for currency volatility: FERT can lead to dramatic swings in the currency's value, which can create uncertainty in international trade and investment.
- Susceptibility to speculative attacks: While volatility can make currency speculation risky, considerable profits are possible if speculators correctly predict the currency's shift.
- Potential for sharp corrections: If a country is running significant trade imbalances, FERT could lead to a sudden, sharp correction in the exchange rate, causing economic shock.

How Flexible Exchange Rate Targeting Changes Economic Dynamics

The implementation of Flexible Exchange Rate Targeting can significantly alter a country's economic dynamics. Firstly, it gives the central bank complete control over domestic monetary policy. It can adjust its policy—be it controlling inflation, managing economic activity, or ensuring financial stability—based on internal, economic indicators rather than being predominantly driven by exchange rate considerations.

Example

For instance, during an economic downturn, a central bank under FERT can choose to lower interest rates to stimulate economic activity, without having to worry about the implications for the exchange rate.

However, this increased flexibility comes with greater exposure to global financial markets. Any geo-political crises, changes in commodities' prices and other global events can significantly impact the country's currency value. As a result, managing macroeconomic stability under FERT requires a careful balancing act between using policy tools such as fiscal policy, monetary policy, and macroprudential regulation.

Advantages and Disadvantages of Exchange Rate Targeting

Exchange Rate Targeting, like any other financial strategy, comes with its sets of benefits and limitations. As you delve deeper into the world of macroeconomics, a comprehensive understanding of these pros and cons becomes essential.

Exploring the Benefits of Exchange Rate Targeting

When executed correctly, Exchange Rate Targeting can offer a wealth of benefits to an economy.

- Currency Stability: One of the most significant advantages of ERT is its potential to provide currency stability. By pegging the domestic currency to a foreign one, ERT can protect an economy from sharp fluctuations in the exchange rate, offering a degree of certainty to both domestic and foreign investors.
- Control Over Inflation: ERT can serve as a useful tool in controlling inflation. When a currency is pegged to a low-inflation currency, a country can essentially import the monetary policy of the low-inflation country.
- Promotion of Trade: ERT can also stimulate international trade. A stable exchange rate removes the uncertainty associated with future fluctuations in the currency value, thereby reducing the risk for importers and exporters. This can promote trade, leading to economic growth.
- Attracting Foreign Investment: A stable exchange rate can make an economy attractive for foreign investors. It reduces the potential risks associated with exchange rate volatility, thereby augmenting foreign direct investment and boosting domestic economic growth.

Case Studies: Successful Use of Exchange Rate Targeting

Examining the use of Exchange Rate Targeting in real-world contexts can offer insightful perspectives on its benefits. Two examples of successful ERT implementation include Germany in the Bretton Woods era and China in the early 21st century.

Example

During the Bretton Woods era (1944-1971), Germany successfully used a fixed exchange rate system to stabilise its currency and rebuild its economy after World War II. By pegging the Deutsche Mark to the US Dollar, Germany was able to control inflation effectively, promote trade, and attract foreign investments.

China, on the other hand, pegged its currency, the Renminbi, to the US Dollar at a relatively undervalued level during the early 21st century. This allowed it to keep its export prices competitive, promoting its manufacturing and export sectors, and driving phenomenal economic growth.

Understanding the Limitations of Exchange Rate Targeting

While ERT offers significant benefits, there are inherent limitations that must be recognised. These include:

- Loss of Monetary Policy Independence: One of the primary drawbacks of ERT is the potential loss of monetary policy independence. With maintaining the exchange rate as a priority, a central bank might not have the flexibility to respond to domestic economic conditions effectively.
- Vulnerability to Foreign Shocks: ERT, particularly in the form of fixed exchange rates, can make an economy vulnerable to foreign shocks. If the currency to which the domestic currency is pegged experiences volatility, it can have a direct impact on the domestic economy.

- Trade Imbalances: ERT can also lead to trade imbalances. If a currency is overvalued, it can make domestic goods more expensive for foreign buyers, leading to a trade deficit. If it's undervalued, it can result in trade surpluses, which can lead to international disputes if sustained over time.

The Risks and Pitfalls in Exchange Rate Targeting Practices

The pitfalls in Exchange Rate Targeting practices can be manifold ranging from economic to geopolitical considerations. A significant risk stems from a sudden stop or reversal of capital flows, commonly known as a currency crisis. This can occur when investors lose confidence in a country's currency and rapidly sell off their holdings, leading to a steep depreciation in the currency value. Managing such a crisis can cost the economy significantly in terms of foreign exchange reserves, economic stability, and growth potential.
Another pitfall entails potential political pressure and perceived lack of credibility. Some governments may face pressure to manipulate the exchange rate for short-term gains, such as boosting exports or reducing the burden of foreign debt. However, such manipulation can lead to long-term economic instability and loss of credibility on international stages.

MONEY SUPPLY TARGETING

Central banks conduct monetary policy by adjusting the supply of money, usually through buying or selling securities in the open market. Open market operations affect short-term interest rates, which in turn influence longer-term rates and economic activity.
Monetary policy is a policy that is an action taken by the Central Bank regarding the activities related in monetary terms. They might be cash, credit, ledgers, mortgage, bonds, debentures, loans, check money markets, etc. The policy is designed by the Central Bank of that particular Nation to regulate the economic imbalances either may be inflation or deflation.
We will know about the monetary policy in this section in detail.

What are the basic aims of monetary policy?
The basic aim of the monetary policy are as follows:
- To regulate inflation.
- To decrease the level of unemployment.
- To increase long term interest rates.
-

Tools of Monetary Policy in India
The Central bank designed the tools of monetary policy. Several central banks will create a common three tools for monetary policy irrespective of the nation. So the basic tools of monetary policy in India are:
Discount Rates
The discount rate is one of the basic terms of monetary policy. The monetary policy aims to stabilize and regulate the nation's economy, which can be fulfilled by a change in discount rates. If the discount rate is reduced, the investors can get less money and take loans from other Banks. It helps any increase in the liquidity of cash. It creates growth in the economy. If the discount rate is high, all the procedures are vice versa.
Requirement of Reserves

Every nation has to maintain some reserves of all kinds of resources, especially financial resources. To maintain these reserves, the government should understand the basic requirements of that particular country. 10 to these results are certain portions of the available funds or investments to the reserve bank. As a result, the Bank of India holds a specific part of the existing money in the form of cash. It is used to lend its customers and also for businesses. It keeps reserves from the deposits and provides them in the form of loans. It also earns some money which may help to maintain the necessities of the Central Bank and the subsidiary Banks.

Growth in Open Market Operations

We all know that a market is a place where we can buy and sell goods. Here the open market refers to the buying and selling of securities from various countries. This is another tool of monetary policy that is designed for trading activity, and it is directed and regulated by the various countries of central banks of that particular Nation with which we make a deal.

What are the Instruments of Monetary Policy?

Instruments of monetary policy in India are categorized into two types. One is qualitative, and the other one is quantitative instruments. These are designed based on the toons of monetary policy which is prescribed by The Reserve Bank of India. Instruments of monetary and credit control will act as an excellent weapon for the country to regulate the demand and supply of resources to that particular nation. So, they have designed these instruments.

Qualitative Instruments

- Credit Rationing
- Licensing
- Requirement of margins
- Dynamic interest rates
- The consumer rate is to be regulated

Quantitative Instruments

- Open market operations
- Bank rates
- Repo rates and reverse repo rates
- Liquidity
- Change in requirement

Who Controls the Monetary Policy in India?

The Reserve Bank of India controls the monetary policy in India. Because it is the central bank of our nation. The instruments of the monetary policy of the RBI, which we have discussed above, can help the RBI to control the money supply and the flow of money to various activities of the nation.

RBI is the central body of India which was established in 1935.it takes care of all the financial transactions and regulates the currency of the country. It provides a set of tools and instruments to maintain monetary policy transparently.

How does the RBI Control the Money Supply in the Economy?

The main objective of the hardware is to control the money supply in the economy to maintain its stability because the Nations should stand properly only with efficient resources. The RBI uses different tools and instruments like cash reserve ratio, statutory liquidity ratio, changes in

repo rate and reverse report, moral suasion, etc. several instruments are in the tools used to maintain the monetary policy.

Objectives of Monetary Policy

- **Bank Credit Expansion**
  One of the most important functions Of RBI is to control the bank credit expansion and supply of money. And special attention is paid to seasonal credit requirements without affecting the stability.
- **Stability of Price**
  Bringing in Price stability also promotes the development of the country's economy. However, the central focus must facilitate an environment favorable to architecture. This helps the development projects to run smoothly without affecting the price stability.
- **Fixed Investment**
  The main aim here is to increase the productivity of investment without affecting non-essential fixed investment.
- **Distribution of Credit**
  Monetary authorities hold rights over decisions for assigning credits to sectors and borrowers. This policy is decided over a specified percentage in order to allocate to desired people
- **Promote Efficiency**
  The central bank pays attention to efficiency to incorporate structural changes. These structural changes include interest rates, operation constraints, and new money market instruments.
- **Reduce Rigidity**
  Reducing rigidity helps to provide considerable autonomy and a sense of flexibility at work. This helps to bring in a competitive environment and diversification among work cultures. Moreover, control over the financial system is maintained and prudence in systems is observed.
- **Inventories**
  Overloading stocks and products getting expired often results in the sickness of organizational units. And hence to avoid these habits, the monetary authority restricts forming inventories by giving a major highlight to prevent idle money in the market.

Monetary Policy Operations

Monetary policy is managed by the Central Bank Of the country. In the case of India, it is managed by the Reserve Bank of India. The operations that come under this policy are as follows:

- Money Supply
- Stability of price
- Interest rate
- Economic Growth
- Financial stability
- Balance of payment
- Stable exchange rate

Key Indicators of Monetary Policy

There are various factors associated with monetary policy. Though it is managed by the Reserve Bank of India it overall affects the country and its economy. According to 2020 report following are the key indicator of the monetary policy:

Indicator	Current Rate
Inflation	2.86%
MSF	4.25%
CRR	3.5%
SLR	18%
Bank rate	4.25%
Repo rate	3.35%
Reverse repo rate	4%
GDP growth rate	6.1%

Monetary Policy Committee

For any organizational work, a good committee is an important requirement. And when it comes to the committee for monetary policy the following people are selected at some specific designations

1. Governor of Reserve Bank of India as chairperson
2. The deputy governor of the Reserve Bank of India as in charge of monetary policy
3. One officer from the Reserve Bank of India
4. Actions of renowned person experts in their own field such as professor research Senior Advisors or committee members.

The primary job of this committee is to observe and manage the daily liquidity work so that the target decides which weighted average Call money rate or WACR is observed.

The Monetary Policy Framework

The reserve bank of India holds full rights to manage and control the monetary policy framework for the county.

The framework aims to provide the following:

- Deciding repo policy rate based on the assessment of situations
- Modulating liquidity conditions to anchor money market

And once, this repo rate is announced, the RBI authority manages day to day appropriate actions with an aim to operate the target.

This framework is tuned and revised accordingly by looking at the market prospectus.

Conclusion

Hunts it is clear that the monetary policy is a proforma or a set of rules imposed by The Reserve bank of India to maintain stability in the growth of the economy. The RBI needs to monitor all the financial transactions in all its forms and to keep up the sufficiency of currency without degrading its value.

MONEY GROWTH TARGETING

Monetary targeting (MT) is a simple rule for monetary policy according to which the central bank manages monetary aggregates as operating and/or intermediate target to influence the ultimate objective, price stability.

VIABLE ALTERNATIVES TO CENTRAL BANKS

In the developed world, the central bank is entrusted with a variety of public responsibilities and is endowed with a corresponding range of executive powers. It provides the national currency, determines its rates of exchange with other currencies, and manages the reserves of foreign assets.

Central banks in developed countries typically operate in a highly complex economy and as part of a sophisticated financial system. The situation in a small developing country may be very different.The financial system may be rudimentary, based on foreign-owned commercial banks that finance commerce and export industries, an informal credit network that serves much of the rural economy, and an existing monetary authority that is little more than a currency board. Many developing countries have not established full-fledged central banks, but instead have created institutions more suited to national needs, capabilities, and aspirations.

In a small developing economy, the scope for monetary policy is very different from that in a complex developed country. Domestic output is determined more by supply conditions and the country's terms of trade than by levels of domestic demand. ble to banks and government. The monetary authorities in small developing countries can also play an important part in promoting indigenous financial institutions. As long as the financial system is dominated by foreign subsidiaries that have access to their parents' reputation, technical expertise, and capital, close banking supervision or provision of lender-oflast-resort facilities may not be a pressing priority. But the monetary authority's regulation and support are essential if local enterprises are to compete successfully and gain the confidence of the deposit-holding public. Indeed the monetary authority may need to be entrepreneurial in setting up or funding new institutions—such as specialized banks, deposit insurance schemes, or unit trusts—which if not immediately profitable are nonetheless important components of a developing financial infrastructure.

It could be argued that what really counts in the final analysis in determining monetary policy is not the legal framework of central banking but the balance of power between the government and monetary authority and the personal relationship involved.

The balance of power between government and monetary authority depends not only on personalities and outside support but also on the institutional framework in which their relations are established .

CENTRAL BANKING IN INDIA

The Reserve Bank of India was established in 1934, under the Reserve Bank of India Act.

Though privately owned initially, it was nationalised in 1949 and since then fully owned by the Ministry of Finance, Government of India (GoI).

The **Reserve Bank of India**, abbreviated as **RBI**, is India's central bank and regulatory body responsible for regulation of the Indian banking system.

Owned by the Ministry of Finance, Government of India, it is responsible for the control, issue and maintaining supply of the Indian rupee.

It also manages the country's main payment systems and works to promote its economic development.

Bharatiya Reserve Bank Note Mudran (BRBNM) is a specialised division of RBI through which it prints and mints Indian currency notes (INR) in two of its currency printing presses located in Mysore (Karnataka; Southern India) and Salboni (West Bengal; Eastern India).

The RBI, along with the Indian Banks' Association, established the National Payments Corporation of India to promote and regulate the payment and settlement systems in India. Deposit Insurance and Credit Guarantee Corporation was established by RBI as one of its specialized division for the purpose of providing insurance of deposits and guaranteeing of credit facilities to all Indian banks.

Until the Monetary Policy Committee was established in 2016,it also had full control over monetary policy in the country.

It commenced its operations on 1 April 1935 in accordance with the Reserve Bank of India Act, 1934.The original share capital was divided into shares of 100 each fully paid. The RBI was nationalized on 1 January 1949, almost a year and a half after India's independence.
The overall direction of the RBI lies with the 21-member central board of directors, composed of: the governor; four deputy governors; two finance ministry representatives (usually the Economic Affairs Secretary and the Financial Services Secretary); ten government-nominated directors; and four directors who represent local boards for Mumbai, Kolkata, Chennai, and Delhi. Each of these local boards consists of five members who represent regional interests and the interests of co-operative and indigenous banks.
It is a member bank of the Asian Clearing Union. The bank is also active in promoting financial inclusion policy and is a leading member of the Alliance for Financial Inclusion (AFI). The bank is often referred to by the name 'Mint Street'.

Central Bank Accountability, Independence, and Transparency

Legal basis
Numerous studies have validated the importance of central banks' independence. Indeed, research based on the IMF's database of central bank legislation shows that most nations' central bank laws contain "anchors," in one form or another, for central bank independence.

Generally, the laws tend to recognize that if politicians manipulate monetary policy to bolster their pre-election popularity, their prioritization of short-term political gains could invite long-term pain for the economy, in the form of higher inflation or even hyper-inflation. This political interference could undermine central banks' goals—such as stable inflation over time and, in some countries, maximum employment—and potentially create long-term risks to economic and financial stability.

Bridging independence and accountability is the notion of transparency, a vital component allowing independent central banks to prove their effectiveness and public accountability.

Former Federal Reserve Chair Janet Yellen cautioned that “sometimes central banks need to do things that are not immediately popular for the health of the economy. We’ve really seen terrible economic outcomes in countries where central banks have been subject to political pressure.”

The Struggle of Central Banks

Since the global financial crisis, many central banks pursued strategies that led to significant expansions of their balance sheets. In some cases, governments tasked them with new or additional financial stability functions on top of their mandate of price stability. In some quarters, concerns about the expanded activities of central banks led to skepticism about the necessity or the appropriate degree of central bank independence.

Indeed, the overall direction and composition of IMF work with country monetary authorities confirms the struggle. In one-fourth of IMF staff visits to provide technical assistance to central bank staff, the discussions include issues related to central bank independence, in one form or another.

Independence and Accountability: Two Sides of the Same Coin

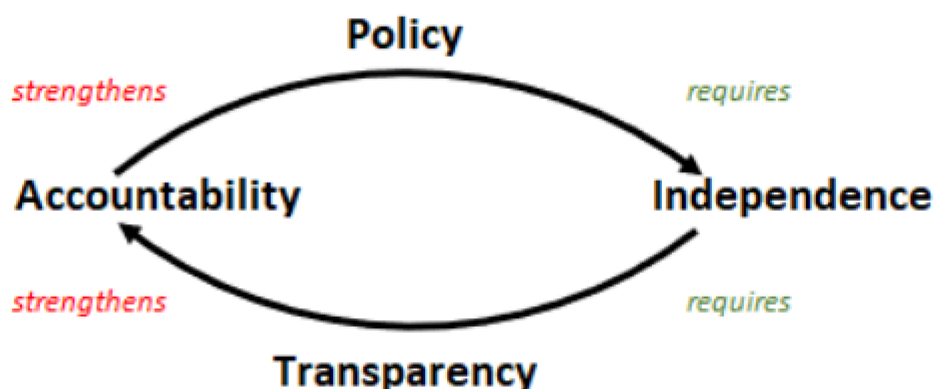
The continuing discussions about central bank independence, in light of post-crisis realities, highlight the fact that central banks do not and should not operate in a vacuum. As public institutions, central banks should be held properly accountable to lawmakers and to society.

Transparency is a key element of this social accountability. Examples of appropriate transparency include the publication of minutes of meetings, responsiveness to lawmakers’ inquiries, the publication of detailed technical reports, meetings with Ministers of Finance, and convening press conferences.

The graphic below highlights the important connections among the key concepts that make up central bank governance. Bridging independence and accountability is the notion of transparency, a vital component allowing independent central banks to prove their effectiveness and public accountability. Or, in the words of South African Reserve Bank Governor, and Chair of the International Monetary and Financial Committee (the Fund’s policy steering committee) Lesetja Kganyago: “For society to appreciate our roles, we… have got to take society along with us, such that when central banks come under attack, it is not just going to be us defending our independence.”

Reinforced connections

Independence requires transparency and provides the basis for sound monetary policy.



Sources: IMF, 2019, Staff Proposal to Update the Monetary and Financial Policies Transparency Code. IMF Policy Paper, May 2019. Washington, D.C.; International Monetary Fund.

INTERNATIONAL MONETARY FUND

Earlier this year, the IMF proposed a new Central Bank Transparency Code. The Code is expected to facilitate greater transparency of central banks on their governance arrangements, policies, operations, outcomes of operations, and interaction with key stakeholders. This should help central banks adapt to their changed environment, as well as provide a continued *raison-d'être* for their independence. The proposal makes clear that modern central banks are expected to explain and justify their actions and give account of the decisions made in the execution of their responsibilities.

Independence and accountability are also needed to ensure good governance and the prevention of institutional decay over the long term. Poor governance and corruption not only harm the economy through short-term disruption, but also take an insidious toll on institutions, weakening their effectiveness. Central banks are not immune.

Guarding independence

Independence surely remains a key principle in ensuring the sound operation of central banks—in particular, from the perspective of their price-stability objective. However, central

banks will need to step up their game. Transparency about their multifaceted decisions and actions needs to be strengthened, and clear communication with the public is paramount. Only by simultaneously enhancing central banks' governance, transparency, and accountability can their long-term independence be assured. This is the surest step to help rebuild public confidence in central banks as reliable defenders of non-inflationary, job-creating economic policies.

Credibility

The credibility of central banks is a crucial factor in maintaining economic stability and trust in the financial system. Central banks' credibility is built on their ability to achieve their inflation targets, maintain financial stability, and communicate effectively with the public and financial markets.

Challenges to Credibility

Central banks face several challenges that can erode their credibility:

1. Inflation: Failure to control inflation can lead to a loss of trust in the central bank's ability to maintain price stability.
2. Communication: Inconsistent or unclear communication can create uncertainty and undermine confidence in the central bank's decisions.
3. Transparency: Lack of transparency in decision-making processes can lead to mistrust and skepticism.
4. Autonomy: Central banks' independence can be threatened by political pressures, which can compromise their credibility.

Building Credibility

To maintain credibility, central banks can:

1. Set clear inflation targets: Establishing clear and achievable inflation targets helps to anchor expectations and maintain trust.
2. Communicate effectively: Transparent and consistent communication helps to build trust and understanding among stakeholders.
3. Demonstrate independence: Central banks must maintain their autonomy to make decisions based on economic data and analysis, rather than political pressures.
4. Foster transparency: Regularly releasing detailed information on monetary policy decisions and operations helps to build trust and accountability.

Recent Developments

Recent events have highlighted the importance of central bank credibility:

1. Inflation fight: The Bank for International Settlements (BIS) has warned that the credibility and autonomy of central banks are at risk if global inflation rates are not brought under control.
2. Transparency: The Bank of Canada has published a detailed summary of its Governing Council deliberations, joining other central banks in promoting transparency and accountability.

3. Central bank credibility: A survey of central bankers found that they agree on the importance of credibility, with a focus on track record and transparency.

Conclusion
Central bank credibility is a delicate balance that requires careful management. By setting clear inflation targets, communicating effectively, demonstrating independence, and fostering transparency, central banks can maintain trust and credibility with the public and financial markets.

Accountability

Central banks play a crucial role in maintaining economic stability and promoting financial growth. However, their actions and decisions can have significant impacts on the economy and society. As such, it is essential to ensure that central banks are accountable for their actions.

Soft Law and Social Accountability
The concept of soft law has gained relevance in central banking, as it provides a framework for social accountability. Soft law refers to non-binding agreements, guidelines, and principles that guide the behavior of central banks. This approach recognizes the importance of transparency, accountability, and cooperation among central banks.

Independence and Accountability
Central banks must balance their independence with accountability. While independence allows central banks to make decisions based on economic considerations, accountability ensures that they are responsible for their actions. This balance is crucial, as it enables central banks to make informed decisions while also being held accountable for their actions.

Transparency and Communication
Transparency and communication are essential components of central bank accountability. Central banks must provide clear and timely information about their policies, decisions, and actions. This helps to build trust and confidence among stakeholders, including the public, governments, and financial markets.

Code of Conduct and Governance
A code of conduct and governance framework can help central banks ensure accountability. This framework outlines the principles and standards that guide central bank behavior, including transparency, accountability, and cooperation.

Quantification of Accountability
Quantifying accountability is essential to evaluate the effectiveness of central bank actions. This can be achieved through metrics such as inflation targeting, financial stability, and economic growth. By tracking these metrics, central banks can demonstrate their accountability and make adjustments to their policies as needed.

Conclusion

In conclusion, accountability is a critical aspect of central banking. Central banks must balance their independence with accountability, provide transparency and communication, and adhere to a code of conduct and governance framework. By doing so, central banks can ensure that they are responsible for their actions and make informed decisions that promote economic stability and growth.

Transparency of Central Banks

Central banks play a crucial role in maintaining economic stability and promoting financial growth. As such, transparency is essential for central banks to demonstrate their accountability, credibility, and effectiveness in achieving their goals. Transparency enables the public, governments, and financial markets to understand the central bank's decision-making processes, policies, and actions, thereby fostering trust and confidence in the institution.

Key Aspects of Central Bank Transparency

1. Clear Communication: Central banks should clearly communicate their goals, policies, and actions to the public, governments, and financial markets. This includes providing regular updates on economic conditions, monetary policy decisions, and financial stability measures.
2. Accountability: Central banks must be accountable for their actions and decisions. This includes providing explanations for policy decisions, justifying their actions, and being transparent about their decision-making processes.
3. Data Disclosure: Central banks should disclose relevant data and information on their activities, including financial statements, balance sheets, and monetary policy decisions.
4. Regular Reporting: Central banks should provide regular reports on their activities, including monetary policy decisions, financial stability measures, and economic outlooks.
5. Public Engagement: Central banks should engage with the public, governments, and financial markets through various channels, including public hearings, town hall meetings, and social media.

Benefits of Central Bank Transparency

1. Increased Credibility: Transparency enhances the central bank's credibility, as it demonstrates its commitment to accountability and openness.
2. Improved Decision-Making: Transparency enables the central bank to make more informed decisions, as it takes into account the views and concerns of the public, governments, and financial markets.
3. Enhanced Public Trust: Transparency fosters trust and confidence in the central bank, as it demonstrates its commitment to serving the public interest.
4. Better Economic Outcomes: Transparency can lead to better economic outcomes, as it enables the central bank to make more effective policy decisions and respond to changing economic conditions.
5. Increased Efficiency: Transparency can reduce the risk of misunderstandings and miscommunication, leading to more efficient decision-making processes.

Challenges and Limitations

1. Balancing Transparency with Confidentiality: Central banks must balance the need for transparency with the need to maintain confidentiality, particularly when dealing with sensitive information.
2. Managing Complexity: Central banks must manage complex information and data, making it challenging to communicate effectively with the public and financial markets.
3. Addressing Information Asymmetry: Central banks must address information asymmetry, where some stakeholders have access to more information than others, to ensure fairness and transparency.
4. Dealing with Uncertainty: Central banks must deal with uncertainty and unpredictability, which can make it challenging to provide clear and accurate information.

Conclusion

Transparency is essential for central banks to maintain their credibility, accountability, and effectiveness. By providing clear communication, accountability, data disclosure, regular reporting, and public engagement, central banks can foster trust and confidence in their institutions. While there are challenges and limitations to achieving transparency, central banks must strive to balance transparency with confidentiality, manage complexity, address information asymmetry, and deal with uncertainty to ensure the best possible outcomes for the economy and society.