Objectives and Functions of Central Banks [1]

Central Banks started primarily involved in the function of currency issuance, and although the Bank of Sweden, established in 1656, was the first to have this right from its state, the beginning of central banking is attributed to the Bank of England which was established in 1694. The central banking practice was established by the Bank of England, then followed by other central banks, including the Bank of Sweden which was founded before it.

Let us consider the reason that made the State confine the right of currency issuance to banks owned by the State or at least under its control. Money changers and later the banks were accepting deposits of coins, prevailing at that time, and giving their owners receipts for their value. Gradually these receipts became acceptable as instruments of settlement among individuals, while the gold or silver deposits were held with banks or money changers for security purposes.

Having these deposits kept with them and feeling certain that the receipts they produced were acceptable in settlement, some of the money changers were encouraged to issue receipts as loans to customers, the value of which exceeded their holdings of coin deposits. Loans of this type were given increasingly to individuals, whose purchasing power thus increased, causing prices to inflate.

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(1) Delivered on March 24, 1986, at the Commercial Institute in Kuwait.

Depression used to happen after price inflation, when depositors needed their money that could not be repaid by banks and money changers where that money was deposited. This situation used to bring about sharp effects of depression, resulting from the failure of these institutions, a fact which led the government to confine the right of issuance to one bank operating under its control.

From the above, it is evident that central banks were primarily established with a supervisory role, through exclusive right of issuing currency within appropriate limits determined in a national perspective.

When other functions started to evolve, gradually stemming from the function of currency issuance, coupled with the necessity of having to hold open accounts with all banks to supply them with money whenever necessary, or vice versa, the currency issuing bank was qualified to act as bankers' bank. These banks began to settle their interbank balances through accounts maintained with the currency issuing bank, and began to deposit their surplus funds with it, a fact that made the bank of currency issuance become the bankers' bank, and lender of the last resort.

Beside the function of currency issuance, these banks played the role of government banks, keeping the government accounts and bearing the costs incurred against the profits obtained from currency issuance operations or from the investment of funds deposited by the governments.

In view of the results of historical experiments stressing the need for supervising banking systems, currency issuing banks (later called central banks) were the best to carry out this function.

Central Bank Ownership and Management:

Almost all central banks are state-owned, although they began as private banks in most countries. Even when these banks were private, the governments were keen on being represented on the boards of these banks, so that the public interest would not be neglected in their decisions.

It should be noted, however, that the management of these banks was not at all subordinated to governments, due to the risk of overfinancing government needs by these banks, if they were completely subject to their governments' desires. This would consequently lead to currency devaluation resulting from over-expansion of currency to finance deficits in government budgets.

To avert this, all international banking legislations contain regulations keeping central banks beyond the scope of their governments' control, securing for these banks independence in management and decision-making. These regulations may be either in the form of clauses, curbing the right of governments to borrow or stipulating the formation of boards of directors in a manner that would enable them to take their decisions freely.

The independence of central bank decision-making is not an absolute concept, as the independence of the central bank traditionally falls within the scope of the government. To explain this it may be said that the general government objectives, regarding both development rates and the size of employment expansion, are binding on central banks. But when a government starts implementing these policies, the central bank may realize that the government estimates are not based on realistic foundations, nor are the estimated resources available to that government, which makes that government borrow from the central bank to meet the deficit in its resources. On the other hand, if the central bank finds that these loans will disturb the monetary stability and will consequently prevent the original objectives from being achieved, the central bank must reject government demands and resort to the method regulated by its governing law regarding the settlement of disputes arising between it and the government.

Role of Central Banks:

Central banks are responsible for the management and implementation of monetary and credit policy in the country. The monetary policy is the policy that aims at the achievement of monetary stability in its comprehensive sense. This stability can be reached by curbing the rise in domestic prices and keeping local currency exchange rates against other major currencies within an appropriate margin.

In this regard we would like to note that the central banks’ responsibility for monetary policy does not mean that they are the only authority that can realize monetary stability as shown above. Policies adopted by other authorities that are responsible either for government expenditure or goods and services have significant effects on that stability. This necessitates coordination among monetary policies, the state general budget and the performance of the goods and services sectors.

The central banks' role in achieving that goal is virtually confined to maintaining the growth rate in domestic liquidity (i.e. M2 which is composed of currency in circulation and various kinds of deposits) to cope with the change in domestic expenditure (government and private). Since it is technically difficult to have direct influence on the major component of domestic liquidity, i.e. deposits, central banks resort to using instruments that secure influence on credit, which represents a key element in creating deposits. Once credit is under control, quantitatively and qualitatively, liquidity growth will be accordingly under control, having the appropriate size and kind.

Instruments of Central Banks:

In the light of the above, central banks use in one way or another the following instruments:

1- Legal Reserve Ratio:

Commercial banks have to deposit with central banks a specified ratio of their deposits. If the aim of central banks is to alleviate the commercial banks' capacity in the expansion of credit, the central banks raise this ratio and vice versa. The liquidity ratio (determining a certain size of liquid assets against liabilities and deposits) may by used to achieve nearly the same goal, as changing the size of liquidity to be kept in the form of liquid assets against a certain size of deposits will affect the size of funds available to any bank for lending.

The main defects of these ratios lie in their validity for curbing expansion in a booming economy, whereas they are invalid to activate a slackened national economy, as reducing ratios and allowing banks to expand their loans will not help to activate the economy. The problem lies in the customers themselves who reduce their activity due to low profitability of projects, and consequently their desire to have productive loans will decline.

2- Open Market Operations:

Central banks absorb surplus liquidity, which commercial banks generally enjoy in boom periods, by means of selling securities to these banks and vice versa. To use this instrument efficiently depends on the availability of sufficient securities.

3- The CBK Lending and Discount Rates:

This means the change in interest rates, upward or downward, on loans extended by the central bank to commercial banks according to its aim. If the central bank aims to increase the ability of these banks to grant credit, it reduces the interest rate and vice versa.

However, this instrument lacks efficiency when commercial banks have sufficient funds and thus have no need to resort to the central bank, where they may be influenced by the discount rate.

4- Qualitative & Direct Measures:

Central banks may intervene through qualitative measures to direct credit from one kind to another by imposing credit margins (ratio of lending on submitted collateral) or prohibiting the financing of a certain activity. Further, central banks may intervene directly and set ceilings for loans that can be extended by banks, for certain kinds of loans or for credit in general.

Due to the negative effects, many central banks are reluctant to adopt or use these measures, unless when it is necessary (when market powers direct banking credit to unfavourable objectives which necessitates direct intervention by the central bank to adjust the course). The major negative effects of these measures lie in reducing the profitability of banks and consequently their endeavour to circumvent these measures, besides the difficulty on the part of central banks to follow up on banks' observance of these measures.

5- Moral Suasion:

Moral suasion is generally the most important method used by central banks and may be the most important instrument in all countries. This method is the only one that has no side effects and its application only needs mutual understanding between banks and the central bank.

In view of the above, as each method or instrument has side effects and certain conditions for its use, the efficiency of using monetary instruments arises from using more than one method simultaneously - in addition to moral suasion - to achieve the goal, with the purpose of not only directing the banks' decisions, but also changing the expectations of individuals.

Functions of Central Banks:

The functions of central banks can be summarized as follows:

1- Regulating the volume of currency to meet the needs of business and individuals in general. Therefore, they are exclusively authorized to issue currency.

2- Carrying out government banking operations on behalf of the government.

3- Maintaining the commercial banks' fund needs.

4- Managing the State's reserves of foreign currencies.

5- Granting credit facilities to banks in any form whatsoever, whether through lending, discounting their commercial papers or re-lending, i.e. the central bank acts as the bankers' bank or lender of last resort.

6- Settling payments among banks through clearing.

7- Supervising credit to be qualitatively and quantitatively in line with economic needs. It implements the monetary policy adopted by the Government.

It is noteworthy to mention that none of the above functions has any priority or importance over the others. Central banks, however, cannot perform efficiently any of the above functions without performing the other functions properly.

Establishment of the Central Bank of Kuwait:

The period between the two world wars (world War I & II) witnessed a kind of monetary disorder, which locally affected certain countries. Perhaps the ineffectiveness of central banks and the limited regional outlook that governed the concept of foreign trade led to those severe effects which resulted from the Great Depression (1929-1933). Whatever the causes and factors that affected this period were, countries had mutually agreed by the end of the Second World War to establish the International Monetary Fund (IMF) and to lay down a basis for evaluating countries' currencies. They also agreed that each country should regulate its monetary affairs to maintain domestic stability (local prices), which had remarkable effects on foreign stability (exchange rate) and thereby on other countries.

Therefore, the post-World War II decade witnessed the establishment of many central banks. Kuwait was not yet independent; it was dealing in the Indian rupee due to the non-existence of local Kuwaiti currency, and thus there was no need for the existence of a central bank.

In 1960 the Kuwaiti Currency Board was established by Amiri Decree No. 41 of 1960 and the Kuwaiti Dinar was put for circulation on April 1, 1961. During the post-independence period 1960-1968 four commercial banks were established, expanding banking activity which entailed the establishment of the Central Bank of Kuwait on June 30, 1968 under Law No. 32 of the year 1968 concerning currency, the Central Bank of Kuwait and the organisation of banking business, to supervise banks and perform other functions of central banks.

Objectives of the Central Bank of Kuwait:

Article (15) of Law No. 32 of the year 1968 stated above provided that the objectives of the Central Bank shall be:

1- to exercise the privilege of the currency issuance on behalf of the state;
2- to secure the stability of the Kuwaiti currency and its free convertibility into foreign currencies;
3- to direct credit policy in a manner that assists social and economic progress and the growth of national income;
4- to control the banking system in the State of Kuwait;
5- to serve as banker to the Government;
6- to render financial advice to the Government.

The above objectives are in harmony with one another on the one hand, and in line with the international concept of central bank objectives on the other. Undoubtedly, the relative novelty in the establishment of the Central Bank of Kuwait enabled it to benefit from other countries' experiences in this respect, resulting in the above stated harmony, which means that the realization of one objective is correlated with the realization of other objectives. The currency issuance will not be efficient unless made in the light of monitoring the general monetary positions of banks and being aware of the expected government expenditure. This awareness of monetary conditions and thereby putting them in the appropriate framework will be reached by the control of the banking system, whereas the identification, or even proposing the adequate volume of the expected government expenditure will be made by the Central Bank's role as banker to the Government and by rendering the adequate financial advice to it. In this respect, light should be cast on both the functions of securing the stability of Kuwaiti currency and the control of banks, due to their importance which is almost equal to the importance of other functions.

The Central Bank Role in the Stability of the Kuwaiti Currency and its Free Convertibility:

The State of Kuwait has adopted a free economy, which was stressed in the provisions of Law No. 32 of 1968 referred to above on securing the stability of currency and its free convertibility to other currencies. The laws of other central banks may seldom provide, among the objectives of the central bank, that the currency should be freely convertible to other currencies. Legislators are generally apprehensive of the emergence of new circumstances that dictate posing restrictions on the convertibility of currency; however, the Kuwaiti legislator specified explicitly the monetary philosophy based on lucid economic principles.

This function was fairly easy for the Central Bank till mid-1972, as exchange rates of currencies had been determined since the establishment of the International Monetary Fund (IMF) according to par values against the U.S. dollar, allowing them to fluctuate within a narrow band of 2.25% more or less. The KD exchange rate was tied to the pound sterling. This undertaking was no longer easy after the adoption of the discipline of floating exchange rates (to find a level in the international exchange market in response to the law of supply and demand without any restrictive effect of artificial support or control), particularly after the second drop of the dollar. It became evident to the Central Bank of Kuwait that an appropriate method should be followed to secure the stability of the Kuwaiti currency after the instability of its reference currencies.

During the next period, up to the beginning of 1975, the Central Bank of Kuwait passed through a transitional stage from being dependent in its exchange rate on a certain currency (the pound sterling) to a discipline of an exchange rate determined by the trade relations of Kuwait with the outside world. During this period the prime concern of the Central Bank was to eliminate the effects of the previous linkage of the KD with pound sterling. For this purpose, the Bank began to announce the KD exchange rate against the dollar and the pound sterling on a day-to-day basis. Next it maintained the KD gold value so that the KD exchange rate would not be markedly affected by the reduction in the dollar exchange rate.

The last stage began in March 1975, during which the CBK could achieve its goal represented in having a free exchange rate between the KD and the dollar. The KD exchange rate was determined by the exchange rate of a basket of currencies, the countries of which had trade relations with Kuwait.

The CBK Scope of Supervision:

First, let us highlight the general concept of supervision, whether over banks or other institutions. Supervision means to adopt certain measures before, during or after operations being performed so as to minimize errors or deviation from set goals. According to this concept, it is impossible to exercise supervision that totally eliminates errors or prevents deviation from the set goals. Work always entails fault or deviation and thereby supervision becomes necessary to curtail both as much as possible.

Supervision over banks, like supervision over other businesses, is a means used to achieve the following two fundamental goals:

- To ensure a certain size of finance that activates the economic sectors.

- To ensure the quality, soundness and recovery of finances.

The growing importance of supervision in banking since the Great Depression in 1929-1933 made some authors define central banks as those performing the function of a credit organization and supervision over it.

It should be noted that the financial institutions subject to Central Bank supervision are not similar in nature and objectives, by which the nature of their resources and their utilization of the same are determined. Therefore, each kind of bank or financial institution should have its appropriate method of supervision. This leads us to point out the major characteristics of each type of institution.

Major Characteristics of Institutions Subject to the Supervision of the Central Bank:

A- Commercial Banks:

The most important characteristics of the commercial banks are:

1- Their main resource of funds is represented by various deposits; current deposits which are drawn by cheques, time deposits or savings accounts.

2- As the major part of these banks' resources is either sight deposits drawn at any time by their depositors or time deposits for a fixed maturity, less than one year in general, these funds should be invested for appropriate maturities, which are short in general.

3- In addition, extending credit by itself leads to an increase in total deposits with the banking system (whether in the same bank or in other banks), which is called “deposit creation”. This means that loans obtained by customers to be used for settlement return again to banks, after one turnover or more in the market, in the form of deposits, either for the same persons or for those dealing with them. And unless credit expansion is associated with an increase in the supply of goods and services, prices will increase owing to a growth in money not associated with similar growth in goods and services.

Therefore, the adequate performance of commercial banks will take place within a framework realizing a pro rata ratio between liquidity and profitability. Investment of funds will not take place on account of liquidity, and if liquidity and profitability are in conflict, liquidity will have priority. Further, good investments and their refundability in due course should be taken into account, whether by the settlement of extended loans and facilities or by the easy sale of financial and real estate investments.

At any rate, these institutions should not freeze their funds in longterm real estate investments, but their possession of real estate should be confined to the appropriate levels of necessary fixed assets such as the bank buildings, places of accommodation and recreation for its employees. Furthermore, banks should not expand the possession of securities that might jeopardize the security necessary for depositors.

Within the previous context, banking legislation lays down rules for commercial banks aiming at the maintenance of bank liquidity and credit-worthiness. These rules also specify the activities that banks are prohibited or not entitled to perform, without the Central Bank's prior approval to keep these banks away from taking the risks that are beyond the nature of their business, as specified in articles 66,67,69 and 70 of Law No. 32 of 1968 referred to above.

It may be beneficial, while discussing the above articles, not to be satisfied only with being aware of the immediate meaning of these articles, but also to deduce the concepts within the framework of which these articles were formulated, among which are the following:

1- The Central Bank does not reject buying the shares of commercial companies, which may be necessary for the national economy. However, banks should take into account that their possession of these shares is within half their fixed financial resources owned by their shareholders. If they have to exceed that limit for national considerations, they must refer to the Central Bank.

2- It is common in banking business that shares and other collateral assets are transferred to the bank in settlement of debts on clients, but unless banks dispose of these assets by sale, they may gradually shift to practise other activities they are not eligible to, especially as they are dealing with funds of others.

3- when the members of bank boards of directors borrow money from their banks, it might involve use of their influence and authority. To avoid such a possibility, they are required to obtain the approval of the bank's owners (general assembly) before these facilities are rendered to them.

B – Specialized Banks:

These banks are characterized by the following:

1- They have been established to finance certain economic sectors, whether this finance is short, medium or long term.

2- In contrast to commercial banks, resources of specialized banks are determined by the quality of the extended finance. While in commercial banks the kind of finance and its maturities are determined by type and maturity of deposits, specialized banks manage to secure their resources in accordance with the quality of the finance provided by them.

3- The basic resources of these banks are represented either in government's contributions and long-term loans, in low interest long-term loans obtained from international financing organizations or in medium and long-term loans obtained from the financial market. Due to the nature of their operations, these banks cannot depend on deposits as a major financing source because they have to maintain a pro rata ratio between sources of funds and their uses.

4- Basically these banks were established to take on active part in economic development, represented in participating in the construction of projects and the support of the infrastructure in the country.

5- Nothing prevents these banks from extending short-term finance, if necessary, provided that they do not neglect their main job.

Going on demonstrating the most important features of the financial system structure, we demonstrate the major characteristics of investment companies.

C- Investment Companies:

During the 1970's, commercial and financial activity grew in Kuwait and thus companies in these sectors expanded. The main aim of these companies is to activate the financial market through trading in financial assets for their own benefit or for others by means of holding their own investment portfolios and other investment portfolios which they manage on behalf of other investors who have confidence in these companies and their ability to manage these investments.

The major characteristics of investment companies are as follows:

1- Their main resources consist of equity funds (funds of their owners) and loans from others, whether in the form of bonds issued by these companies or loans with fixed maturities. They are not allowed to accept deposits, otherwise their activities are changed into banking, a fact which obligates them to move in the direction that gives them this capacity, either with regard to registration or supervision regulations specified by the law.

2- The main investments of these companies are in various kinds of securities. They may have deposits with banks. But whenever these companies go beyond the scope of their main objectives shown above, expanding their possession of different goods for sale or freezing their funds in real assets and becoming vulnerable to the circumstances prevailing in the real estate market, they deviate from their main objective as financial investment companies.

   It is significant to note in this regard, that due to the absence of rules regulating the scope of work of these companies, when established, many of these companies include in their articles of associations activities (trading and real estate business) other than their main activities (financial).

3- If these companies exercise both financial and non-financial activities, it will be impossible for them to follow up their financial activities unless they separate these activities and allocate certain units to carry them out.

4- Fund management carried out by the company on behalf of others should be separated from the company’s own activity lest the outcome of operations be mixed up, giving rise to negative effects by letting somebody bear consequences of an activity he is not responsible for.

Despite the absence of rules regulating the business of these companies at present, the CBK is monitoring their activities to ensure that they have sound financial positions and they abide by their articles of association. In addition, the CBK supports the credit-worthiness of these companies.

Last but not least, we come to money-changing companies to demonstrate the most important features and characteristics of their activities.

D- Exchange Companies or Money-Changers:

The free Kuwaiti economy which entails free convertibility of currency in Kuwait's market, coupled with the growing economic activity in the country, led into increasing the role of exchange institutions and thereby other economic units.

Money-changing means the replacement of foreign currency with local currency and vice versa, against a fixed ratio of profit. Undoubtedly, the existence of several nationalities in Kuwait gives exchange institutions an important and vital role.

It was noticed, however, that the expanding activity of certain money-changers encouraged them to practise banking business such as accepting deposits, extending loans and representing foreign banking institutions. Therefore, in March 1984 a ministerial resolution was passed regulating the profession of money-changing by specified rules limiting this business to the activity of changing currencies, travel cheques, drafts, trading in precious metals, collecting cheques and foreign drafts, prohibiting money-changers from practising banking business, either locally or by representing a foreign bank.

Exchange companies were granted a grace period to observe the above mentioned decision and to adjust their positions and abstain from any actions violating the provisions of this decision.

The CBK Supervisory Role:

After demonstrating the similarities and differences between units operating in the financial or banking field, it is time to highlight the instruments of supervision. Article 72 of Law No. 32 of 1968 referred to before, authorizes the CBK board of directors to set rules and regulations that should be observed by all banks to ensure their liquidity and credit-worthiness at ratios and relations between resources of banks and their investments. Further, these regulations specify the method by which banks should invest their funds and determine their applicable interest rates. At present, all financial institutions mentioned above are subject to CBK supervision.

The most important instruments used currently by the Central Bank of Kuwait are the following:

Liquidity Ratio:

This ratio is to determine certain components of assets to be in liquid form, corresponding with the maturities of liabilities and deposits.

Perhaps this ratio was first thought of as an endeavour to ensure bank liquidity and to maintain the ability of banks to meet any contingent obligation. This concept has been expanded at present in many countries and is being used to curb risky bank expansion. This means that central banks may oblige banks to keep a certain amount of liquid assets over what is required to cover their needs. By this, central banks aim to prevent banks from credit expansion. This ratio has been used in Kuwait since the mid-1970's. Banks provide the Central Bank of Kuwait with fortnightly data indicating their liquidity.

The Central Bank Lending & Discount Rate and Debit & Credit Interest Rate:

The rates of discounting and rediscounting of commercial papers range between 6% on 3-month papers and 6 ¾% on one-year papers, in accordance with a system specifying the papers that might be rediscounted at the CBK. Further, the maximum interest rate on loans to customers is determined at 10%, with maximum sub-rates on loans extended for guaranteed productive purposes at 7% and at 8.5% on non-guaranteed productive loans. A minimum interest rate of 4.5% is determined on savings deposits.

Rates stated above are not valid for interest rates on interbank transactions within the money market, as sometimes short-term money surpluses are available at certain banks, while other banks have liquidity shortages. Interest rates in this market are determined by the volume of overall supply of surplus banks and the overall demand for funds by the deficit banks.

The CBK very carefully monitors rates in that market and intervenes with a supply of or a demand for funds at appropriate rates when rates begin to fluctuate widely opposing the CBK aim of monetary stability. And since this intervention directly influences the volume of liquidity at banks and the cost of their resources, it is regarded as a form of open market operations and almost realizes the same goal achieved by the traditional method, with a slight difference only in the form of procedure corresponding to the movement of deposits between the Central Bank and banks.

Rules of Credit Rationalization :

The rules of credit rationalization were set in the light of banks' tendency to grant the major portion of their loans without collateral. Therefore, a lending ceiling was decided for banks' unsecured loans at a certain ratio of total loans granted to customers. The banks' expansion in granting unsecured loans together with the banks' failure to follow up the use of these loans in accordance with the objectives they were originally granted for, led to non-performing loans. Therefore, the CBK had to enact the credit rationalization rules to maintain the effectiveness of bank credit, safeguarding it as much as possible from any side effects.

Setting a Ceiling for Loans that One Customer Might Obtain from One Bank:

This procedure was similar to procedures adopted by many countries in the world to keep banks from taking the risk of lending money to a customer more than a certain limit determined by the bank's own funds or its capital. The system adopted in Kuwait aims at safeguarding any bank against the risk of overdrafts or unsecured loans granted to one customer.

Method of Supervision:

As mentioned above, supervision originates from objectives, within which the framework of policies are formulated. Then the method of work should be drawn in a manner that guarantees these banks to abide by the adopted policies. Methods of supervision may take the form of office or field supervision, as follows:

- **Office Supervision**: It means to provide the Central bank regularly with periodic data indicating:

    - How far the concerned bank is adhering to the Central Bank's instructions (to follow up on decisions such as liquidity data).

- How far the components of data items are consistent with the required ones (to follow up on the relative distribution of these items and the relative importance of each one of them).

- Soundness of the investment policies (to follow up on the change in resources and uses).

- The discovery of certain violations by checking the relevant data.

- **Field Supervision**: It means moving to banks' premises to verify figures and data sent by these banks, their regular books and their observance of central bank instructions. Article No. 78 of the Law No.32 of 1968 referred to above provided that the Central Bank may at any time inspect banks and financial institutions subject to Central Bank supervision.

Towards More Effectiveness by the Central Bank:

To increase the Central Bank's effectiveness the following should be done:

1- Gradual improvement in all banking fields, either regarding the efficiency of financial positions of units subject to its supervision or the policies it adopts.

2- Building up provisions necessary for the settlement of bad debts and adjusting the financial structures of financial institutions.

3- Reviewing bank lending policies to reach sound bases that would protect banking business in the future.

4- Co-ordination with the government so that the State's policies are complimentary to one another, either in the monetary, fiscal or real field.

Fortunately, the Kuwaiti economy possesses the elements of strength that should enable it to overcome problems. These elements are represented in an integral infrastructure in addition to a continuous rise in the ratio of non-oil GDP. Added to this, seriousness in tackling problems, coupled with optimal utilization of the available reserves, would make facing any problem with the least side effects quite possible.