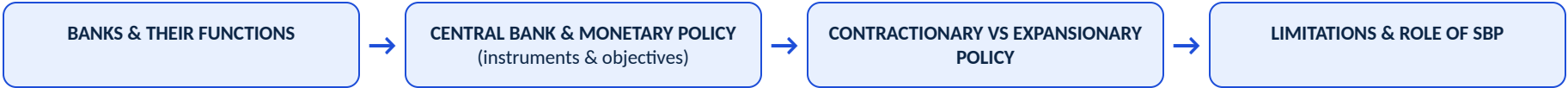


1 CHAPTER ROADMAP



Theme: banks evolved from goldsmiths' receipts into today's formal system, with commercial banks creating credit and the central bank overseeing the whole system. Monetary policy is the central bank's key tool – manipulating money supply and interest rates via quantitative and qualitative instruments to hit macroeconomic objectives.

2 KEY DEFINITIONS

Bank A financial institute licensed by the government to receive deposits, which it then invests in a number of securities.	Financial Intermediary A financial institution through which savers can indirectly provide funds to borrowers.
Central Bank The state institution authorized to provide banking/financial services to commercial banks and government; implements state policy and controls currency issuance & circulation.	Credit A contractual agreement whereby a borrower receives something of value in the present, in exchange for payment in the future, generally with interest.
Credit Creation Process by which a commercial bank increases the supply of money through creation of new deposits in the name of borrowers.	Monetary Policy Measures taken by the central bank to influence macroeconomic activity, especially by manoeuvring money supply and credit through changing interest rates.
Open Market Operations (OMOs) Buying or selling government securities in the open market to change the level of reserves held by commercial banks.	Expansionary vs Contractionary Monetary Policy Expansionary: used to STIMULATE demand. Contractionary: used to REDUCE demand.

3 FUNCTIONS OF COMMERCIAL BANKS

RECEIVING DEPOSITS

- Primary function; public earns interest on surplus funds

ADVANCING LOANS

- Deposits are a liability; loans issued against interest

DISCOUNTING BILLS OF EXCHANGE

- Bank pays seller early against a bill, deducting a discount

LOCKERS FACILITY

- Safekeeping of valuables for a nominal fee

CREDIT CREATION

- Generates further loanable funds from deposits (see p.4)

4 FUNCTIONS OF THE CENTRAL BANK

Note Issuance

Sole authority to issue & maintain currency supply.

Fixed Fiduciary: notes issued up to a limit need no backing; beyond it, 100% reserves required.

Proportional Reserve: a fixed % (Pakistan: 30–40%) of gold/silver/forex must back all notes issued.

Banker to the Government

Advises & funds government projects, like a commercial bank does for customers.

Banker to the Banks

Holds commercial banks' cash reserves centrally – builds confidence & buffers financial shocks; offers counselling in difficulty.

Lender of Last Resort

Provides liquidity to commercial banks unable to meet requirements elsewhere – protects savers' deposits.

Exchange Rate Controls

Uses forex & gold reserves to manage exchange rates and balance of payments.

Clearing Agent

Commercial banks hold accounts with the central bank, reducing need to physically issue/transfer cash between banks.

CUSTODIAN OF MONETARY RESERVES

- Holds/safeguards gold & foreign currency reserves for the country

5 INSTRUMENTS OF MONETARY POLICY: QUANTITATIVE CONTROLS

1. BANK RATE (DISCOUNT RATE)

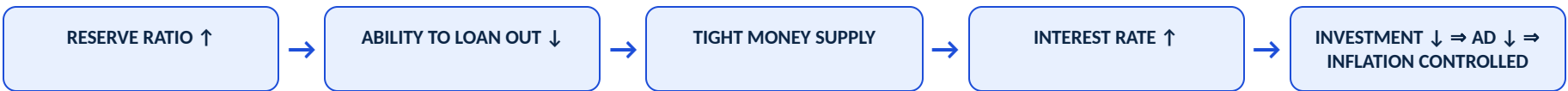
- Rate at which the central bank rediscounts bills of exchange / lends to commercial banks



2. OPEN MARKET OPERATIONS (OMOS) - EXAMPLE: SELLING RS.1BN IN BONDS



3. CHANGES IN RESERVE REQUIREMENT



4. CREDIT RATIONING

- Central bank fixes the MAXIMUM limit of loans commercial banks may issue – adjusting this limit controls money supply

6 INSTRUMENTS OF MONETARY POLICY: QUALITATIVE CONTROLS

CHANGES IN MARGINAL REQUIREMENT

- Gap between security value demanded and loan actually issued – adjusting it controls credit

MORAL PERSUASION

- Central bank personally discusses with/persuades banks against risky actions

DIRECT ACTION

- Severe measure for non-cooperative banks: fines, refused discount facility, altered bank rate

SPECIAL DEPOSIT

- Attractive short-term deposit offered to banks – withdraws money from the market

PRUDENTIAL CONTROL

- Regulations/articles on credit volume issued by the central bank

7 QUANTITATIVE VS QUALITATIVE CONTROLS

	Quantitative Controls	Qualitative Controls
Target	Overall VOLUME/level of credit & money supply	DIRECTION/composition & behaviour of credit
Examples	Bank rate, OMOs, reserve requirement, credit rationing	Marginal requirement, moral persuasion, direct action, special deposits, prudential control

8 CREDIT MULTIPLIER (MONEY MULTIPLIER)

CREDIT/MONEY MULTIPLIER

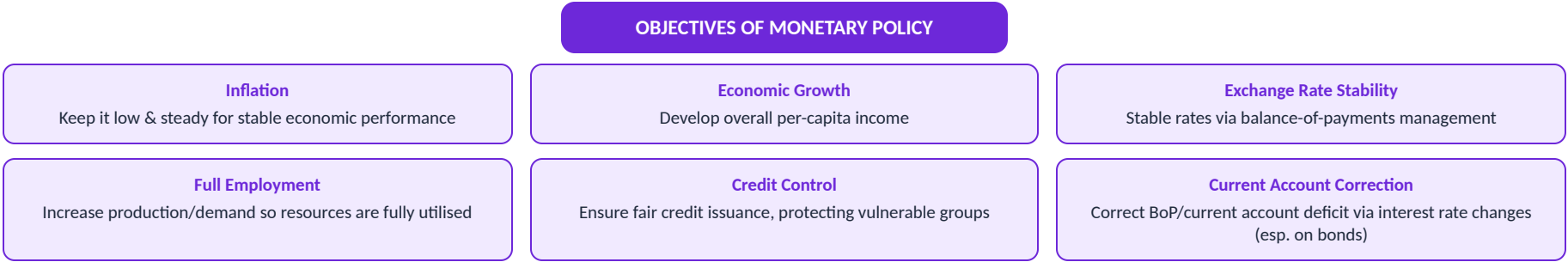
Credit Multiplier = 1 ÷ Reserve Ratio | Total Credit Created = Initial Deposit × Credit Multiplier

The credit multiplier is the RECIPROCAL of the reserve ratio

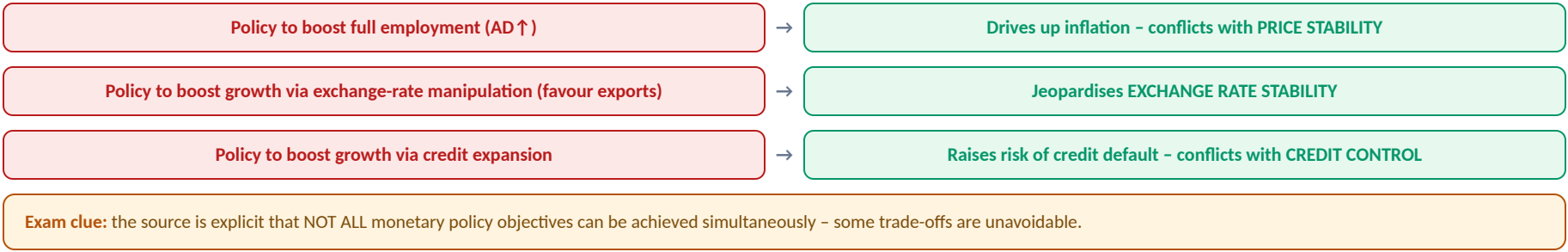
Worked example: Reserve ratio = 40%; Initial deposit = Rs.10,000 ⇒ Credit Multiplier = 1÷0.4 = 2.5 ⇒ Total Credit Created = 10,000×2.5 = **Rs.25,000**.

Exam clue: a LOWER reserve ratio means a LARGER credit multiplier (more deposits can be created from the same initial deposit) – and vice versa.

9 OBJECTIVES OF MONETARY POLICY



10 CONFLICTS BETWEEN MONETARY POLICY OBJECTIVES



11 CONTRACTIONARY VS EXPANSIONARY MONETARY POLICY

	Contractionary (Anti-Inflationary)	Expansionary (Anti-Deflationary)
Central bank action	Raises interest rate / raises reserve requirement	Buys government bonds from commercial banks
Effect on reserves	Commercial bank reserves EFFECTIVELY reduced	Commercial bank cash reserves ↑
Bank response	Reduce loans issued / raise borrowing cost	Loan out additional reserves (multiplied across banks)
Effect on consumption/investment	Both FALL (disposable income ↓ , investment disincentivised)	Both RISE (lower market interest rate)
Effect on AD	Decreases	Increases
Effect on Output & Price	Output falls Y1→Y2; Price falls P1→P2	Output rises Y1→Y2; Price rises P1→P2

Contractionary: AD shifts LEFT



Expansionary: AD shifts RIGHT



12 LIMITATIONS OF MONETARY POLICY

- **Non-monetary sector:** in developing countries, barter-reliant groups don't use banks – policy can't reach them
- **Non-banking financial institutions:** offer credit but fall outside central bank supervision
- **High liquidity in financial markets:** agents can create their own liquidity, blunting a tightening policy
- **Time lags:** effects take time to materialise, forcing the central bank to predict an uncertain future
- **Lack of coordination with fiscal policy:** central bank (monetary) and government (fiscal) working at cross purposes undermines effectiveness

13 ROLE OF THE STATE BANK OF PAKISTAN (SBP)

CORE ROLES

- Prepares Pakistan's monetary policy
- Organizes/manages the entire banking & financial system
- Controls foreign reserves, currency rate & currency supply
- Controls inflation via open market operations (currency circulation, interest rate, forex rate, bank loans)

INSTITUTIONS & INITIATIVES

- **NBP** (National Bank of Pakistan): largest commercial bank, SBP's treasury agent
- **ZTB** (Zarai Taraqiyati Bank) & **IDBP**: soft loans for agriculture & industry development
- Promotes Islamic banking (separate deposit counters)
- Supports exporters (easy remittances, incentives); discourages unnecessary imports (esp. luxury goods)

14 EXAM PATTERNS & MCQ QUICK CLUES

"Rediscounting bills of exchange"



Bank Rate

"Buying/selling govt. securities in open market"



Open Market Operations

"Central bank personally discourages a bank's action"



Moral Persuasion (qualitative control)

"Reserve ratio given + initial deposit"



Credit Multiplier = $1 + \text{Reserve Ratio}$

"Central bank raises interest rate/reserve requirement"



Contractionary Monetary Policy

"Central bank buys bonds from commercial banks"



Expansionary Monetary Policy

⚠ ECONOMICS EXAM TRAPS

Trap: Confusing Quantitative controls (volume of credit: bank rate, OMOs, reserve requirement) with Qualitative controls (direction/behaviour: moral persuasion, direct action).

Trap: Mixing up Fixed Fiduciary System (fixed limit, then 100% backed) with Proportional Reserve System (ongoing % backing, used in Pakistan).

Trap: Assuming all monetary policy objectives can be met at once – the source explicitly notes conflicts exist (e.g. full employment vs price stability).

Trap: Reversing contractionary vs expansionary effects on reserves – contractionary REDUCES commercial bank reserves/lending; expansionary INCREASES them.

Trap: Forgetting the credit multiplier is the RECIPROCAL of the reserve ratio, not the ratio itself.

15 COMPLETE CHAPTER DECISION TREE

QUESTION GIVEN → Bank function, central bank function, monetary policy instrument, or contractionary/expansionary question? → Identify specific concept (which instrument/function/objective) → If numerical: apply credit multiplier formula → Trace the cause-effect chain (rate/reserve change → money supply → interest rate → AD) → Interpret & select final answer

PRC-3 ECONOMICS – CHAPTER 11 IN 60 SECONDS

- **Bank:** licensed to receive deposits & invest funds; functions include deposits, loans, bill discounting, lockers, credit creation.
- **Central bank functions:** note issuance, banker to govt/banks, lender of last resort, exchange control, clearing agent, custodian of reserves.
- **Quantitative controls:** bank rate, OMOs, reserve requirement, credit rationing.
- **Qualitative controls:** marginal requirement, moral persuasion, direct action, special deposit, prudential control.
- **Credit multiplier** = $1/\text{Reserve Ratio}$; Total Credit = Deposit × Multiplier.
- **6 objectives:** inflation, growth, exchange rate stability, full employment, credit control, current account correction – not all achievable together.
- **Contractionary:** rate/reserve ↑ → AD ↓ → output & price fall. **Expansionary:** reverse.
- **Limitations:** non-monetary sector, non-bank institutions, high liquidity, time lags, poor fiscal coordination.
- **SBP:** Pakistan's central bank – monetary policy, reserves, inflation control, NBP/ZTB/IDBP, Islamic banking.

16 CHAPTER MEMORY MAP

Bank Functions

Central Bank Functions

Note Issuance Systems

Quantitative Controls

Qualitative Controls

Credit Multiplier

Objectives & Conflicts

Contractionary vs Expansionary

Limitations of Monetary Policy

Role of SBP