Chapter 15

Money and Banking

Abstract

This chapter is aimed at describing the financial system and its structure as a whole. Here, financial market, financial system, financial intermediary and their types, the banking system and some details about the central bank are given. Financial market is a comprehensive term which shows any marketplace, where customer and trader contribute in the trade of assets such as equities, bonds, legal tenders and derivatives. Multiple components of these markets make the financial system at different level. In these markets intermediation has an important role, they help to channel funds between deficit and surplus agents. Nearly every economy has its financial markets around the globe. Some of them are small with limited number of contributors, however, others like the Karachi Stock Exchange (KSE) and the foreign exchange markets trade billions of dollars daily.

Keywords: equities, bonds, legal tenders, foreign exchange, financial intermediary

15.1. Financial Market

It is a market of purchase and sale where entities and people can trade commodities, financial securities, like, bounds, stocks and other items at lower cost of transaction that appear in the form of demand and supply.

Most of the financial markets have periods, where heavy trade for the demand of securities occur and cause increase in the prices that may rise the historical norms. In contrast, it may downturn and cause a fall in the prices from the past intrinsic value, based on the less demand and macroeconomic forces, as level of employment, output (NI) and tax rate. To enhance the participant's confidence, transparency of information is necessary and it is also important for the efficient and faster financial marketplace.

15.2. Financial System

This system can be regional, worldwide and on a specific firm level. The firm's financial system is a set of restrictions by the firm that keep an eye on the financial activities of the firm. On regional scale, a financial system is a system in which borrowers and lenders can exchange funds. Infect the global financial system is the larger regional system that encompasses all the borrowers, lenders and institutions within global economy (Campbell at al. 1997). Multiple components make the financial system at different level; within a firm, the financial system includes all financial aspects. For example, it would include accounting measure, schedules of revenue and expense, verification of balance sheet and wages. Regional financial system includes financial market, banks, financial services and other financial institutions. On the global level, financial system, it includes central bank, World Bank, International Monetary Fund and other major banks.

15.3. Financial Intermediary

These bodies help in channeling funds between deficit and surplus agents. A financial intermediary system creates relation between surplus and deficit agents. It can also be defined in terms of financial institutions (like credit union, banks, finance company, stock exchange, insurance company and brokerage company), which acts as third person between borrowers and lenders [Hillier at al. (2011) and Colin (1990)]. Bank is the example of financial intermediary that transforms the funds into the bank loans.

15.3.1. Advantages of Financial Intermediaries

There are two definite benefits of using financial intermediaries,

1) Benefit of cost over direct borrowing
2) Protection of market failure to conflict the needs of borrowers and lenders are sort out to prevent the market failure

15.4. Types of Financial Intermediaries

15.4.1. Banks

A bank is an organization or financial institution that receives deposits and uses these deposits into lending activities, either indirectly, by means of capital market or directly, by loaning. A bank is the interaction between the capital surplus and capital deficit of the costumers. Generally, banks are regulated highly in most countries due to these influences. Many banks operate under fractional reserve banking, in which they have less reserve of fund deposit and lend out for the profit. Generally, they are subjected to the requirement of the minimum capital on the set of international capital standers that is known as Basel Accords.

15.4.2. Building Society

A financial institution in which mutual organization is done by its members is called a building society. It offers financial and related banking services, especially the mortgage of lending. These institutions are present in UK and in many other countries. This term first rose in the 18th century from the cooperating saving groups in Great Britain. Today in UK, these societies are actively competing with the banks for the banking consumer services, especially saving accounts and lending mortgage.

In Pakistan, House Building Finance Cooperation is working. Its primary objective is to provide the population of low and middle income group low cost housing solutions by appreciating the new constructions in medium and small housing sector.

15.4.3. Credit Union

It is a participant of cooperative finance and it is domestically organized by its members, and work to promote thrift, issues of loaning on competitive rates and issue other financial facilities to its stakeholders.

Mostly, these bodies render the services to aid the community or sustainable international development on the local level and these can also be called community development financial institutions. On the worldwide, credit union system is very important based on average institution asset size, total assets system and lot of members.

15.4.4. Financial Advisor or Broker

A financial advisor or Broker is a professional that helps to present the financial services to the client. The word financial advisor or financial planner is common that is used in professional investment, they are the important part of group of professional investors, these could include, brokers, accountants, insurance agents, investment advisor, financial planners and lawyers.

A broker is a party (brokerage firm) or individual that manages the transactions between a seller and a buyer and gains commission when the deal is completed. A broker also behaves like a buyer and a seller, and becomes a party to the deal. Distinguished agent is one who behaves on the behalf of the party. Usually, broker is an individual agent and it has important role in some of industries. The main responsibility of the broker is to bring buyers and sellers together. So, we can say that a broker is a third person that plays the role of facilitator between buyer and seller. An example may be a real estate broker who helps the sale of property. An example may be a stockbroker, who makes possible sale and purchase of securities on the client's behalf. Broker play extensive role in the sale bonds, stocks and other financial services.

15.4.5. Insurance

A justifiable transfer of risk of loss from the one entity to another for the exchange of payment is called insurance. It is a type of risk management and used to overcome the loss. The insurance carrier is a company that sells insurance. The policyholder or insured is a person or entity who buy the insurance policy. The amount of money that is charged on specific insurance amount coverage is called premium. The policyholder gets contracts called insurance policy, which details the circumstances and conditions under which the policyholder will be compensated officially.

15.4.6. Collective Investment Scheme

It is a method of investing money with the other investors to gain benefits of working as a group from the inherent advantages. It has following benefits including, hiring of professional investment manager that generally offers the batter prospects of risk management or returns. It also causes economies of scale and it reduce the risk theoretically.

This can differ for country to country but investment vehicles are mostly stated as, mutual funds, investment funds or simply funds. In the larger markets, collective investment has been developed and it accounts for the substantial part of all the trading on huge stock exchange. Collective investment is promoted through huge amount of investment and aims either trading specific industry sector (e.g. technology) or specific geographic region. Depending on the country, there is usually bias towards the domestic market to represent national self-interest. Funds are mostly selected on the basis of previous investment performance, specific investment objectives and other factors like fees.

15.4.7. Pension Funds

It is basically a scheme, fund or plan that offers the income of the retirement. These funds are essential to private companies and shareholders. Especially, they are pivotal to the stock market where many institutional investors dominate.

15.4.8. Stock Exchange

It is basically a type of exchange that gives services for stock brokers and traders to stocks trade, bonds and other securities. It provides financial instruments, redemption of securities, capital events along with payment of income, dividends and facilities for issue. Securities that are traded on stock exchange include the share provided by the companies, derivatives, bonds, unit trust and pooled investment products.

To enable for trade a security or stock exchange should be listed for the record. This is generally a main location, but there is possibility that trade is not much associated to some physical place, as modern markets are electronic. These markets provide advantage of speed and has minimized the cost of transactions. Trade on an exchange is done by the members only. Bonds and stocks to investors are offered in primary markets and subsequent is done in the secondary markets. It is oftenly the most significant part of the stock market. Demand and supply in financial market are driven through many factors.

15.4.9. Zarai Taraqaiti Bank Limited (ZTBL)

ZTBL is known as Agricultural Development Bank of Pakistan (ADBP). It is the primary financial institution that brings agriculture sector towards the development through technical knowhow and provision of the financial services. The reconstruction of ABDP is carried out with the object to uplift the rural and agriculture sector by increasing farm productivity, and raising the capacity of income and streamlining the institutional credit. On 14th December, 1961, ZTBL was introduced as a public Limited company through ABD ordinance.

The corporate structure defines the status of the bank as a public limited company registered under the companies with the object of assuring autonomy, good governance and delivering high quality. ZTBL is delivering; affordable agriculture and rural financial, and non-financial services to the Pakistan's rural population. Through 359 branches of country, wide network is serving annually around half million clients and serving 68 percent. Total assets of bank are about Rs. 123 billion. In total national institutional credit, ZTBL has the share of 23 percent.

15.5. The Banking System

15.5.1. What Business Do?

On worldwide banks are accounting in trillion of assets, the bank is the vital component of the global economy. Money lending and money changing may be as old as money. In 15th century, banking dates back mediaeval Italy and play an important role to rise the city status of Italian as world economic power. Banks are just only one part of the world of standing alongside the investment banks, insurance companies, financial institutions, investment managers, finance companies and other companies that gain profit from the flow and creation of money. Given how much individual wealth and commerce rests on healthy banks, these are among the most regulated business in the world.

15.5.2. Accept Deposit / Make Loans

Basic function of banks is to accept the customer's deposit, raise capital from lenders and investors, and then use this capital to make loans, purchase securities and provide different services to the customers. Then these credits are used by the consumers and business to purchase good and enhance business operations, which in return creates more deposited funds that make their way to the banks. At higher interest rate if banks can lend money than they have to pay for operating costs and funds, they make money.

15.5.3. Provide Safety

Banks also provide other services and security to their customers. In the past, goldsmith used to predate the customers. This was back in a time when the wealth of a person consisted on actual silver and gold coins, but this system is still alive. By keeping physical cash in wallet or at home, there is risk of loss of money due to accidents and theft, without mention the loss of possible income from interest. Now in the recent era of banks, people are not needed to keep huge amount of money at hand; transactions can be done with checks, credit card, debit card, instead. In the same way banks, don't keep silver or gold bullion as currency on hand anymore, many, still banks maintain valuate and rent out space to the customers in terms of safe deposit boxes. This permits customers to keep valuable commodities in secure setting and provide the bank an opportunity to earn less extra money, without bearing its capital risk.

15.5.4. Act as Payment Agents

Under appreciating role is also performed by the banks within a county and between nations. Banks are not only involved in the business of debit and credit card but these institutes are also engaged with other institutions for wire transfer transactions. Banks necessarily underwrite by credibility to their transaction and lending their reputation; a cheque is usually just a simple note between two people, but if it has not the details of bank, then it will not be accepted in the market. Banks make commercial transactions easily, and now a days it not needed to carry lot of currency note as now banks have.

15.5.5. Banking Operations

15.5.5.1. Retail Banking

Avery one know about the retail banking system. This type of banking is the business of making mortgages, customer loans and offering products, like a checking account and taking deposits. In order to take benefits of these services, individual is required to have account at any branch of bank.

Retail banks mostly compete for the services they provide to the customers, like, the accessibility of ATMs and number of branches, account service fees, interest rate on loans. These institute also offers many other services to consumers, who have saving accounts along with the checking and transfer retirement accounts.

15.5.5.2. Business Banking

This type of banking is not much different from the customer retail banking. Its operations focuses on loans issuance, collection of deposits and motivating the clients to other fee-generating services. One feature that make these two types different is that business customers have more sophisticated demand from banks. Mostly leaning on banks for helping in managing their receivables, payables and other treasury functions than the retail banking. Business banking also tend to be less demanding in infrastructure and branch network, but more competitive in the form of fees and its rates.

15.5.5.3. Private Banking

There are a small number of independent financial institutions that exclusively emphasize on private this type of banking, as it is operated as a department of larger bank. This banking is like a euphemism for banking and financial services are offered to top level customers. Further, to standard bank service, like saving and checking accounts and safe deposit boxes, private banks mostly offer a host of trust, estate planning services and tax. Specific laws of countries about banks as the case of Switzerland have made them beautiful locations for private banking.

15.5.5.4. Investment Banking

In these banking operations, underwriting securities, advisory services to cooperate clients, and trading for accounts are mainly focused. Underwriting derivatives can be a potential problem for investment bank.

So, it can be concluded from the above, that banking systems are there, as long as people are using money. Banks are quite important to the economy and are involved in several beneficial economic activities. History has proven banks to be vulnerable to many risks as well. Many global crises have been the result of such vulnerabilities and this has led to the strict regulation of state and national banks.

Box 15.1: Interest free banking

"In 1980's there was the establishment of so called interest free banking system in Pakistan. But its attributes were given importance in 2001 by policy makers as a tool of attracting investments. Pakistan is experiencing a significant growth during the last decade and expecting to double its market share by 2020. Yet there is a long distance to cover to match the leaders of Islamic finance in Malaysia & Dubai. Total assets of these banks in Pakistan are above Rs. 900bn. Total 375 Islamic banks exist and 110 conventional banks in Pakistan. Islamic finance in Pakistan can be explored to attract the huge share in the scenario of equitable distribution of wealth and fair trade. According to the Prime Minister of Pakistan Mr. Shahbaz Sharif, it can help to create a link between Muslim World and West, and also helpful in clearing the image of Pakistani's that they can also excel in their tasks to contribute in the prosperity and promote Islamic finance".

***Source:** Khan and Bhatti (2006)*

15.6. Central Bank

It is a monetary authority, and it is a public institution that manages the currency of state, interest rate and money supply. In Pakistan, State Bank is the central bank, and it look after the commercial banking system of economy. In contrary to a commercial bank, a central bank has authority to implement monetary policy, and prints the national currency that serves as the nation's legal tender.

The main function of the central bank is to control the money supply of country. It implements monetary policy to correct the system when needed. This institute has supervisory power intended to control the risk and avoid bank runs in other financial institutions and commercial banks if thery are engage in fraudulent or reckless behavior (Deane and Pringle 1994). To be independent from the political interferences in the most developed nations, these banks are institutionally designed.

Chief executive of the central bank is generally known as a president, Governor or chairman.

15.6.1. Functions of a Central Bank

Functions of central bank include,

- Imposing monetary policy (details are given in Chapter 13)
- Interest rate determination
- Controlling entire national money supply
- The bankers' bank ("lender of last resort") and the Government's banker
- Manage the foreign exchange of the country and the Government's stock register and gold reserve
- Supervising and regulating the banking industry
- Official interest rate setting that is use to manage both country's exchange rate and inflation, and convincing this rate takes the affect via a variety of policies mechanism.

15.7. Fed and Great Depression and Friedman's Criticism

If we want to see why government reserve do not come down, great depression of USA is good example. At that time, USA central bank had two months to enhance the money supply, by purchasing the securities from the other banks and other option was to reduce the interest rate that it charges from other banks. Between, October 1929 and February 1930, the USA central banks just supplied the money in the economy. It made major purchases of U.S. securities, and cut interest rates from 6 to 4 percent. Due to high money, it could not purchase much of securities but, it reduced the interest rate (Christiano et al. 2004).

Friedman was one of most significant free market advocate of last five decades and he transferred us a vast intellectual legacy, comprising his description about Great Depression. Fed aggravating the Great Depression not because it intervened, but because it did not intervene as much as it should. It is a good example of, how laissez-faire policies failed to head off the depression. Friedman's explanation has not been widely recognized and accepted. It maybe the due to the reason, it does not lend itself to quick sound bites by politicians eager to justify more power. Or maybe it is usually presented in a way that makes it too difficult for the layperson to understand (Friedman 1970).

15.8. Global Financial System

It is the international body of legal arrangements, institutions both formal and informal economic actors that help global movement of capital to resolve investment and trade financing. It was formed at the end of 19th century during the initial stage of economic globalization. After its foundation, central banks, multilateral treaties, and intergovernmental institutions we established in order to enhance the transparency, regulation, and effectiveness of global level markets (James and Patomaki 2008).

15.9. International Monetary Fund (IMF)

This is also a global institution and it is comprised of 189 nations. It is aimed at improving the international monetary collaboration, protect financial steadiness, smoothen the global trade, help in reducing unemployment and viable economic growth, and control the poverty throughout the world. It was founded in 1945, it is governed by all member nations. It basic objective is to ensure the smooth and steady global monetary system. And, this system is comprised of exchange rates and international payments that help member nations to transact mutually. Its protocols were revised in 2012 and now it scopes include all macroeconomic and financial problems as well that bear on global stability.

15.10. World Bank

In 1944, the World Bank has expanded from a single institution to a closely associated group of five development institutions. Its mission evolved from the International Bank for Reconstruction and Development (IBRD) as facilitator of post-war reconstruction and development to the present-day mandate of worldwide poverty alleviation in close coordination with our affiliate, the International Development Association, and other members of the World Bank Group, the International Finance Corporation (IFC), the Multilateral Guarantee Agency (MIGA), and the International Centre for the Settlement of Investment Disputes (ICSID). Reconstruction remains an important part of our work. However, at today's World Bank, poverty reduction through an inclusive and sustainable globalization remains the overarching goal of our work.

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