CENTRAL BANKING

The functions of central banks

A journalist is interviewing Professor John Webb, an expert in central banking.

What are the main functions of central banks?

Well, most countries have a central bank that provides financial services to the government and to the banking system. If a group of countries have a common currency, for example the euro, they also share a central bank, such as the European Central Bank in Frankfurt.

Some central banks are responsible for monetary policy – trying to control the rate of inflation to maintain financial stability. This involves changing interest rates. The aim is to protect the value of the currency – what it will purchase at home and in other currencies.

In many countries, the central bank supervises and regulates the banking system and the whole financial sector. It also collects financial data and publishes statistics, and provides financial information for consumers. In most countries, the central bank prints and issues currency – putting banknotes into circulation. It also participates in clearing cheques (see Unit 21) and settling debts among commercial banks.

The central bank and the commercial banks

How exactly does the central bank supervise the commercial banks?

Well, commercial banks have to keep reserves – a certain amount of their deposits – for customers who want to withdraw their money. These are held by the central bank, which can also change the **reserve–asset ratio** – the minimum percentage of its deposits a bank has to keep in its reserves.

If one bank goes bankrupt, it can quickly affect the stability of the whole financial system. And if depositors think a bank is unsafe they might all try to withdraw their money. If this happens it's called a **bank run** or a **run on the bank**, and the bank will quickly use up its reserves. Central banks can act as **lender of last resort**, which means lending money to financial institutions in difficulty, to allow them to make payments. But central banks don't always **bail out** or rescue banks in difficulty, because this could lead banks to take risks that are too big.

Central banks and exchange rates

What about exchange rates with foreign currencies?

Central banks manage a country's reserves of **gold** and foreign currencies. They can try to have an influence on the **exchange rate** – the price at which their currency can be converted into other currencies. They do this by **intervening** on the **currency markets**, and moving the rate up or down by buying or selling their currency. (See Unit 44) This changes the balance of **supply** – how much is being sold – and **demand** – how much is being bought.

Match the two parts of the sentences. Look at A and B opposite to help you.

1 The central bank will sometimes lend money
2 Banks would probably start taking too many risks
3 Central banks are usually responsible for
4 The central bank can alter
5 There will be low and stable inflation

a if they could always be sure of rescue by the central bank.
b if there is a run on a commercial bank.
c if monetary policy is successful.
d printing and distributing banknotes.
e the amount of money commercial banks are able to lend.

Complete the text from the website of the Federal Reserve, the central bank of the United States. Look at A opposite to help you.

Today the Federal Reserve's duties fall into four general areas:

- conducting the nation's (a) .... policy;
- (b) .... and regulating banking institutions and protecting the credit rights of consumers;
- maintaining the (c) .... of the financial system; and
- providing certain (d) .... services to the US government, the public, financial institutions, and foreign official institutions.

Make word combinations using a word from each box. One word can be used twice. Then use the word combinations to complete the sentences below. Look at A, B and C opposite to help you.

bank	markets
currency	run
exchange	system
financial	policy
monetary	rate
	stability

1 ...., including setting interest rates, is designed to maintain ....
....

2 If there's a .... and the bank goes bankrupt, this can have a rapid effect on the whole ....

3 On one day in 1992, the Bank of England lost over £1 billion (more than half of the country's foreign reserves) in the ...., trying to protect the ....
.... of the pound.

Over to you

Is the central bank in your country independent from the government? What powers and responsibilities does it have?