

Role of Central Banks

Central banks are responsible for maintaining stability in the financial system and helping governments achieve their macroeconomic objectives.

Implementation of Monetary Policy

Central banks implement monetary policy to influence inflation, economic growth and overall economic activity.

They can use several monetary policy tools:

- Changing interest rates , For example the Bank of England raised its base rate from **0.1% in late 2021 to a peak of 5.25% in 2023**
- Buying or selling government bonds
- Changing reserve requirements for commercial banks

Banker to the Government

The central bank acts as the government's bank by managing its accounts, receiving tax revenues and making government payments.

For example, although the UK Government sets its annual budget, the central bank helps manage the flow of government receipts and payments.

Central banks can also help governments issue and manage government debt, such as government bonds.

Banker to the Banks – Lender of Last Resort

The central bank acts as the **lender of last resort**, meaning commercial banks can borrow from it when they face short-term liquidity problems.

For example, a bank may experience a sudden increase in customers withdrawing their deposits and temporarily lack enough liquid funds to meet these withdrawals.

Central bank provides emergency funding → banks can meet withdrawals → bank failure may be prevented → confidence in the banking system is maintained → risk of systemic financial instability falls.

Without a lender of last resort, liquidity problems could cause otherwise viable banks to fail, potentially resulting in households losing savings and instability spreading to other banks.

Regulation of the Banking Industry

Central banks can help regulate commercial banks to maintain financial stability and protect consumers.

This is particularly important because financial markets contain high levels of asymmetric information, meaning consumers may have less information about financial products and risks than financial institutions.

Central banks may impose regulations such as:

- Minimum capital requirements . For example the BOE enforces strict CET1 capital ratios above 10-14% for major UK banks (pre 2008 was less than 4%)
- Required reserve ratios
- Risk management requirements
- Regular monitoring of banks

A **required reserve ratio** determines the proportion of deposits banks must keep in reserve rather than lend out.

Higher reserve ratio → banks have less money available to lend → money supply falls → banks become more resilient to withdrawals.