What Are Central Banks?

by Reem Heakal (Contact Author | Biography)

The central bank has been described as "the lender of last resort", which means that it is responsible for providing its economy with funds when commercial banks cannot cover a supply shortage. In other words, the central bank prevents the country's banking system from failing. However, the primary goal of central banks is to provide their countries' currencies with price stability by controlling inflation. A central bank also acts as the regulatory authority of a country's monetary policy and is the sole provider and printer of notes and coins in circulation. Time has proven that the central bank can best function in these capacities by remaining independent from government fiscal policy and therefore uninfluenced by the political concerns of any regime. The central bank should also be completely divested of any commercial banking interests.

The Rise of the Central Bank

Today the central bank is government owned but separate from the country's ministry of finance. Although the central bank is frequently termed the "government's bank" because it handles the buying and selling of government bonds and other instruments, political decisions should not influence central bank operations. Of course, the nature of the relationship between the central bank and the ruling regime varies from country to country and continues to evolve with time. To ensure the stability of a country's currency, the central bank should be the regulator and authority in the banking and monetary systems.

Historically, the role of the central bank has been growing, some may argue, since the establishment of the Bank of England in 1694. It is, however, generally agreed upon that the concept of the modern central bank did not appear until the 20th century as problems developed in the commercial banking system. Thus, the central bank's modern function emerged in response to an already present commercial banking structure.

Between 1870 and 1914, when world currencies were pegged to the gold standard (GS), maintaining price stability was a lot easier because the amount of gold available was limited. Consequently, monetary expansion could not occur simply from a political decision to print more money, so inflation was easier to control. The central bank at that time was primarily responsible for maintaining the convertibility of gold into currency; it issued notes based on a country's reserves of gold.

At the outbreak of WWI, the GS was abandoned, and it came apparent that, in times of crisis, governments, facing budget deficits (because it costs money to wage war) and needing greater resources, will order the printing of more money. As governments did so, they encountered inflation. After WWI, many governments opted to go back to the GS to try to stabilize their economies. With this rose the awareness of the importance of the central bank's independence from the political machine.

During the unsettling times of the Great Depression and the aftermath of WWII, world governments predominantly favored a return to a central bank dependent on the political decision making process. This view emerged mostly from the need to establish control over war-shattered economies; furthermore, countries with newly-acquired independence opted to keep control over all aspects of their countries - a backlash against colonialism. The rise of managed economies in the Eastern Bloc was also responsible for increased government interference in the macroeconomy. Soon after the effects of WWII, however, the independence of the central bank from the government came back into fashion in Western economies and has prevailed as the optimal way to achieve a liberal and stable economic regime.

How the Bank Influences an Economy
A central bank can be said to have two main kinds of functions: (1) macroeconomic when regulating inflation and price stability and (2) microeconomic when functioning as a lender of last resort.

Macroeconomic Influences
As it is responsible for price stability, the central bank must regulate the level of inflation by controlling money supplies by means of monetary policy. The central bank performs open market transactions that either inject the market with liquidity or absorb extra funds, directly affecting the level of inflation. To increase the amount of money in circulation and decrease the interest rate (cost) for borrowing, the central bank can buy government bonds, bills, or other government-issued notes. This buying can, however, also lead to higher inflation. When it needs to absorb money to reduce inflation, the central bank will sell government bonds on the open market, which increases the interest rate and discourages borrowing. Open market operations are the key means by which a central bank controls inflation, money supply, and price stability. If you'd like to learn more about this subject, see this *The Federal Reserve (the Fed) Tutorial*.

Microeconomic Influences
The establishment of central banks as lender of last resort has pushed the need for their freedom from commercial banking. A commercial bank offers funds to clients on a first come, first serve basis. If the commercial bank does not have enough liquidity to meet its clients' demands (commercial banks typically do not hold reserves equal to the needs of the entire market), the commercial bank can turn to the central bank to borrow additional funds. This provides the system with stability in an objective way; central banks cannot favor any particular commercial bank. As such, many central banks will hold commercial-bank reserves that are based on a ratio of each commercial bank's deposits. Thus, a central bank may require all commercial banks to keep, for example, a 1:10 reserve/deposit ratio. Enforcing a policy of commercial bank reserves functions as another means to control money supply in the market. Not all central banks, however, require commercial banks to deposit reserves. The United Kingdom, for example, does not have this policy while the United States does.

The rate at which commercial banks and other lending facilities can borrow short-term funds from the central bank is called the discount rate (which is set by the central bank and provides a base rate for interest rates). It has been argued that, for open market transactions to become more efficient, the discount rate should keep the banks from perpetual borrowing, which would disrupt the market's money supply and the central bank's monetary policy. By borrowing too much, the commercial bank will be circulating more money in the system. Use of the discount rate can be restricted by making it unattractive when used repeatedly.

Transitional Economies

Today developing economies are faced with issues such as the transition from managed to free market economies. The main concern is often controlling inflation. This can lead to the creation of an independent central bank but can take some time, given that many developing nations maintain control over their economies in an effort to retain control of their power. But government intervention, whether direct or indirect through fiscal policy, can stunt central bank development. Unfortunately, many developing nations are faced with civil disorder or war, which can force a government to divert funds away from the development of the economy as a whole. Nonetheless, one factor that seems to be confirmed is that, for a market economy to develop, a stable currency (whether achieved through a fixed or floating exchange rate) is needed. However, the central banks in both industrial and emerging economies are dynamic because there is no guaranteed way to run an economy regardless of its stage of development.

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