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Curso de inglés económico, de finanzas y tributos
Module 5
Central Banking

1. Definition of Central Bank

Central bank is a nation’s main monetary authority, which is able to conduct certain monetary practices. (**Monetary** means “relating to money.”)

Most countries have a central bank to oversee their banking system. The central bank may be owned and controlled by the government or it may have considerable political independence.

The **Federal Reserve System** is the central bank of the United States and is commonly called the Fed. The Fed is an independent organization within the government, which has both public and private characteristics. In Europe, countries share a central bank, 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 to protect the value of the currency.

In many countries, the central bank supervises and regulates the banking system and the whole financial sector; it collects financial data and publishes statistics, and provides financial information for consumers.

In most countries, the central bank prints and issues currency (putting the bank notes into circulation). It also participates in clearing cheques and settling debts among commercial banks.

Today, more than 160 nations have central banks. As we have seen, these banks function as the main monetary authority for their respective nations. They also serve the same purpose— maintaining economic stability. Further, they use similar tools to fulfill this purpose. Even so, these central banks do have several differences.

One difference is historical. The Federal Reserve, for example, was established by an act of Congress in 1913. The Bank of England, Great Britain’s central bank, claims a royal pedigree, having been established in 1694 during the reign of William and Mary. In China, the People’s Bank of China (PBC) began as a commercial bank in 1948. It functioned as a central bank and a commercial bank until 1983, when it was reorganized solely as a central bank.

Another difference lies in the production of money. The central banks of Great Britain and China both produce and distribute currency. In the United States, the Treasury produces currency and the Federal Reserve distributes it.

2. Common duties of Central Banks

There are three common duties that all central banks perform:

- **HOLDING RESERVES**

Central banks are sometimes called reserve banks. Banks lend only a part of their funds to individuals and businesses and keep the rest in reserve. The central bank holds these reserves to influence the amount of loanable funds banks have available. This allows the central bank to control the money supply.

- **ASSURING STABILITY OF THE BANKING AND MONETARY SYSTEMS**

The central bank also acts to assure stability in the national banking and monetary systems. For example, it is one of the banking regulatory agencies that regulate and supervise banks to make sure that they act in ways that serve the interests of depositors and of the economy. Also, by controlling the way money is issued and circulated, the central bank attempts to avoid the confusion that might result when individual banks issue their own bank notes.

- **LENDING MONEY TO BANKS AND THE GOVERNMENT**

The final duty of the central bank involves one of the primary functions of all banks— it lends money. Its lending practices are unlike those other banks, however. It does not seek to make a profit through lending, and it serves private banks and the government rather than individual customers and businesses.

As the banker's bank, a Central Bank has the responsibility of helping banks do their jobs. It serves the banking system in a variety of ways, including providing check clearing and other services that facilitate the transfer of funds, lending money, and regulating and supervising banking activity.

Each Central Bank supervises the practices of state or province member banks and bank holding companies in its district. A **bank holding company** is a company that owns, or has a controlling interest in, more than one bank. This supervision includes **bank exams**,

which are audits of the bank's financial practices. These exams make sure that banks are not engaged in risky or fraudulent practices, especially in lending.
Furthermore, the Central bank monitors bank mergers to ensure that competition is maintained and enforces truth-in-lending laws to protect consumers in such areas as home mortgages, auto loans, and retail credit.

3. Central Banks and Commercial Banks

Commercial banks have to keep reserves (certain amount of their deposits) for customers who want to withdraw their money, as we have seen in our previous class. These are held by the central bank, which can also change the **reserve ratio**.

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 money. If this happens, it is called a **bank run** or **run on the bank**. The bank will quickly use up its reserves.

Banks often loan each other money on a short-term basis. Sometimes all the banks in a region are faced with short-term cash flow issues, usually during natural disasters. At such times, the Central Bank will provide loans to banks and may charge reduced interest rates. In addition, smaller banks that have seasonal cash flow needs due to the nature of their local economy may borrow from the Central Bank.

It also acts as the **lender of last resort** to prevent a banking crisis, lending money to banks in difficulty to allow them to make payment. But central banks do not always **bail out** (or rescue) banks in difficulty, because this could lead banks to take risks that are too big.

4. Central Banks as Government's banker. The Fed (U.S.)

Central Banks also serve as the national government's banker; the government uses this money on a variety of programs through direct spending and transfer payments.

In its role as the national government's banker, the Central Bank also fulfills certain fiscal responsibilities by helping the government to carry out its taxation and spending activities.

In the U.S., the Fed provides the following services:

- **Paying Government Bills**, which include programs such as Social Security, Medicare, and IRS tax refunds, military personnel, their wages and benefits are processed through the Fed.
  Direct government spending also comes from accounts at the Fed. Whether the government is buying office supplies or military equipment or paying contractors to maintain federal highways, the money is funneled through the Fed.
  The Fed also processes food stamps, which are issued by the Department of Agriculture, and postal money orders, which are issued by the U.S. Postal Service. The Fed, therefore, facilitates government payments in a way that is similar to the way it clears checks and processes electronic payments in the private sector.

- **Selling Government Securities.** The government has different kinds of securities that it sells when it wants to borrow money. Remember that securities are another name for bonds and stocks.
  The Fed processes U.S. savings bonds and auctions other kinds of securities for the U.S. Treasury to provide funds for various government activities. The Fed has many roles in this process. It provides information about the securities to potential buyers, receives orders from customers, collects payments from buyers, credits the funds to the Treasury's account, and delivers the bonds to their owners. It also pays the interest on these bonds on a regular basis or at maturity. Many of these transactions are now handled electronically. Even when individuals purchase government securities on the Treasury Department's Web site, the Fed transfers funds between the purchaser and the Treasury and pays the interest when it is due. The Fed does not charge fees for these services.

- **Issuing/distributing currency.** One of the important functions of a central bank is to issue a standard currency that is used throughout the economy. In the United States, Federal Reserve notes are the official paper currency. These notes are money backed by the confidence of the federal government and managed by the Federal Reserve. The Department of the Treasury's Bureau of Engraving and Printing prints Federal Reserve notes, which are distributed by the Fed to its district banks. The notes are then moved on to depository institutions and finally into the hands of individuals and businesses. The Fed makes sure that bills are distributed to banks in the amounts that they need. Paper money has a life span of between two and five years. Smaller denomination bills tend to have a shorter life span. Larger denomination bills stay in circulation longer. When bills get worn out, they are taken out of circulation, destroyed, and replaced with new ones. In a similar way, the Fed distributes coins that are produced by the **U.S. Mint**.

5. Central Banking and Money Supply

Money supply can be defined as the stock of money and the supply of new money. It consists of currency in circulation and bank deposits.

There are different types of measuring money: the smallest one is called **narrow money** (currency and sight deposits) and **broad money**, which includes savings deposits and time deposits (e.g. certificates of deposits).

We can also measure money by knowing how often it is spent in a given period. This is known as **velocity of circulation** (how quickly it moves from one institution or bank account to another).

6. Central Banks and Interest Rates – Margin or Spread

There are different kinds of interest rate.

The **discount rate** is the one set by the Central Bank to lend short-term funds to commercial Banks. When this rate changes, the commercial Banks change their own **base rate** or **prime rate**, the rate they charge their most reliable customers like large corporations. This is the rate from which they calculate all their deposit and lending rates for savers and borrowers.

Banks make their profits from the difference, known as **a margin or spread**, between the interest rates they charge borrowers and the rates they pay to depositors.

The rate borrowers pay depends on their **creditworthiness**, also known as **credit standing** or **credit rating.** This is the lender's estimation of a borrower's present and future solvency: their ability to pay. The higher the borrower's solvency, the lower interest rate they pay.

7. Monetary policies

Monetary authorities sometimes use monetary policies to try to control the amount of money in circulation and its growth in order to prevent inflation. There follow the most common monetary policies implemented by governments and central banks.

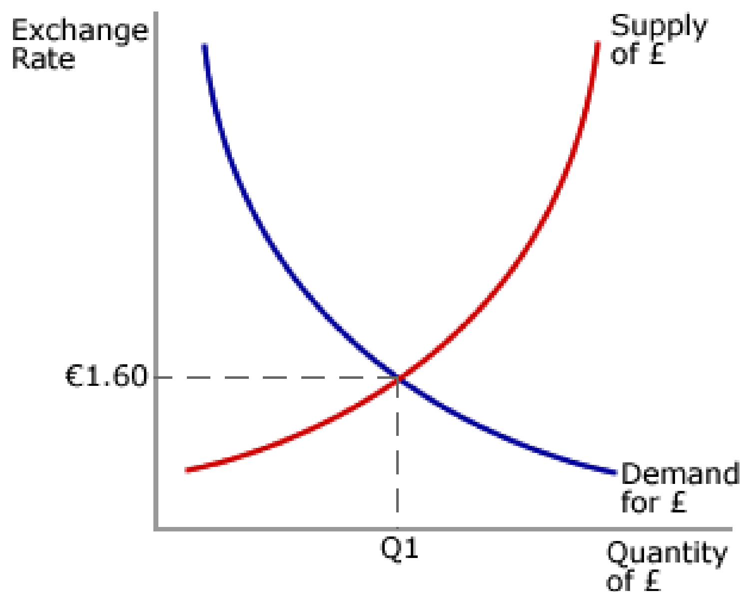
- **Changes in the discount rate** for short term loans to commercial banks, by which the lower interest rates are, the more money people and business borrow, increasing the money supply.

- **Changing commercial banks reserve-asset ratio:** the percentage of deposits a bank has to keep in its reserves when depositors want to withdraw their money. The more a bank has to keep, the less it can lend.
- **Buying and selling treasury bills in open-market operations with commercial banks**. If the Central Bank buys back these bills, they will supply commercial banks with more money to lend.

8. Central Bank and Exchange Rates

As you know, every country has its own currency. Some countries in an economic zone share a currency, for example the Euro. So when we travel to another country, we need to exchange currencies. The **exchange rate** is the price at which certain currency can be converted into another currency.

Most exchange rates do not stay the same, they are changing all the time, as the price of a currency is decided by supply and demand in the market. The rate set will be the equilibrium point where supply and demand meet.



Demand comes from different sources. For example, a country's exports need to be paid in a foreign currency. When this happens, the demand for such currency increases, attracting investors to buy that currency with prospects of making a profit. Supply comes from people who want to sell their currency. For example, people who want to

buy imports from countries abroad, or want to invest in countries abroad, they must sell their currency to buy foreign currencies. So, the supply of such a currency increases.

Central banks manage a country's reserves of gold and foreign currencies. Therefore, they try to have an influence on the exchange rate. They do this by intervening on the currency markets, and moving the rate up or down by buying or selling their currency.

In theory, exchange rates should be at the level that gives purchasing power parity (PPP). If the price level in a country increases because of inflation, its currency should depreciate and its exchange rate should go down in order to return to PPT. As a result, it takes more of your currency to buy the same products in other countries.

But, in fact, PPP doesn't work as exchange rates can change due to currency speculation, those who look for high interest rates or short-term capital gains if a currency increases in value or appreciates. Banks and currency traders make considerable profits from the spread between a currency's buying and selling prices.

In the past, exchange rates were **fixed** or **pegged** against gold. Since 1970s, there has been a system of floating exchange rates, which is determined by people buying and selling currencies in the foreign exchange markets. This **floating exchange rate** is determined by market forces of supply and demand. Therefore, governments and central banks try to change the value of their currency by using foreign currency reserve to buy their own currency, in order to raise its value or selling to lower it. These resulting rates are known as **managed floating rates**.

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