The Role of Central Banks in Modern Economy

When you think about a bank, perhaps the first thing that pops into your mind is the place where you manage your finances through services and products like deposits and loans. However, there is a financial institution that doesn't have a commercial focus but that plays a key role in the economy and that is also called a bank: a central bank.

A central bank is a public institution that is responsible for implementing monetary policy, managing the currency of a country, or group of countries, and controlling the money supply.

Central banks represent a country's financial institution but they can also represent a group of them. The eurozone is an example of a financial institution made up of a group of countries. In this case, the power falls under the Eurosystem, which is made up of two fundamental parts: the European Central Bank (ECB) and the national central banks of the eurozone's member states that have the euro as their official currency. The Bank of Spain, the Deutsche Bundesbank and the National Bank of Poland (Narodowy Bank Polski, NBP) are some examples.

Central banks were initially created to establish reliable payment systems and incentivize citizens to put their trust into the local currencies. While developed economies around the world became more and more sophisticated, central banks' responsibilities and capabilities grew accordingly. When the first central bank was created in Sweden in 1668, it was tasked with lending the government funds and to act as a clearing house for commerce. In the next four centuries the role of a central bank transitioned from an independent entity controlling the money supply to an entity that works cooperatively with the government to ensure economic and financial stability of a country.

Central banks play a crucial role in the modern economy, tasked with managing monetary policy and ensuring overall economic health. Their main objective is maintaining price stability, which implies keeping inflation at a low and steady rate.

This is achieved through a careful balance of monetary controls like adjusting interest rates and regulating the money supply. In addition, central banks strive for a stable economic performance, which is characterized by high employment levels and sustainable economic growth. Central banks' efforts are directed towards smoothing out the fluctuations in the business cycle and cushioning the economy against potential shocks. Lastly, another focus is on financial stability, ensuring a smooth-running payments system and averting financial crises. This involves a diverse set of strategies, ranging from prudent reserve management to the deployment of macroprudential policies, all aimed at strengthening the financial system against vulnerabilities and promoting enduring economic stability.

the main responsibilities central banks

1. **Defining monetary policy** – central banks set macroeconomic objectives such as to ensure price stability and economic growth. To do this, financial authorities have tools like setting official interest rates, which have an impact on the cost of money. Based on the economic situation, central banks will opt to either increase official interest rates (to control inflation, for example) or decrease them (to encourage consumption and boost economic growth).

2. **Regulating money in circulation** – they are the authority for issuing coins and notes, the money supply, and for regulating how much money is in circulation. Central banks do this to inject liquidity into the economy so that different economic agents (families, companies and States) can use it in their transactions. With regard to currencies, central banks are also responsible for carrying out operations to ensure that exchange rates remain stable, as well for owning and controlling their official reserves.

3. **Overseeing the inter-bank market** – they ensure that the relevant financial laws are respected and they monitor national payment systems to make sure that they are working properly.

4. **Loaning liquidity to commercial banks if necessary for solvency issues** – aside from the loans made between institutions in the inter-bank market, as mentioned in the previous bullet point, commercial banks can also receive liquidity from central banks in exchange for collateral, such as guaranteed

public bonds. This means that, if required, commercial banking institutions can cover what they need in the short-term, while the central banks try and ensure price stability by mediating in credit fluctuations.

5. **Taking on an advisory role** – they regularly produce studies and reports that are useful for governments or private organizations, for example.

How the Central 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.

1. 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. Their actions directly influence market sentiment. The central bank performs open market transactions (OMO) 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 prices.

2. Microeconomic Influences

The establishment of central banks as lenders of last resort has pushed the need for their freedom from commercial banking.

If the commercial bank does not have enough liquidity to meet its clients' demands, 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 reserve/deposit ratio. Enforcing a policy of commercial bank reserves functions as another means to control the money supply in the market.

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 for interest rates).

It has been argued that, 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. The use of the discount rate can be restricted by making it unattractive when used repeatedly.

In conclusion, central banks do all of this independently of the political group in power in any given country, as they aim to ensure the stability of the financial system. Their decisions are directly dependent on the supervisory body that composes the financial institution.

- ***Text based Activities***

1. **answer the following qustions:**

6. What is the primary purpose of a central bank?
7. Why were central banks originally created, and how has their role evolved?
8. How does a central bank maintain price stability?
9. Explain the role of central banks in the inter-bank market.
10. How does a central bank differ from a commercial bank?

2. **Determine whether the following statements are true or false:**

- Central banks work with governments to ensure financial and economic stability.
- One of the main goals of a central bank's monetary policy is to achieve low inflation.
- Central banks are heavily influenced by political groups in setting financial policies.

- Central banks aim to increase economic stability by adjusting interest rates and controlling the money supply.
- The role of a central bank in the inter-bank market includes ensuring that laws are respected.
- Central banks are responsible for providing loans and deposits to the public.
- Adjusting interest rates is a tool used by central banks to influence inflation and economic growth.

3. **Fill in the Blanks**

Complete the following sentences based on the text:

- Central banks aim to ensure _______ by keeping inflation low and steady.
- One of the roles of central banks is to oversee the ________ market to ensure financial laws are respected.
- When commercial banks face liquidity issues, central banks can provide short-term funds in exchange for ________.
- Central banks implement ________ policies to smooth out fluctuations in the business cycle.
- Central banks regulate ____________ by issuing coins and notes and ensuring stable exchange rates.
- In the Eurosystem, the ____________ and national central banks work together to oversee the eurozone's currency.

4. **Match each central bank responsibility with its correct description.**

Responsibility	**Description**
1. Defining Monetary Policy	A. Ensures that payment systems and transactions between banks run smoothly.
2. Regulating Money in Circulation	B. Involves conducting studies and producing reports for governments and private organizations.
3. Overseeing the Inter-bank Market	C. Adjusts official interest rates to control inflation or boost economic growth.

4. Loaning Liquidity to Commercial Banks	D. Involves issuing coins and notes, regulating the money supply, and managing official reserves.
5. Advisory Role	E. Provides short-term loans to commercial banks to ensure their solvency, usually with collateral.