

## Central Banks' Function and Role

Definition: A central bank is an independent national authority that conducts monetary policy, regulates banks, and provides financial services including economic research. Its goals are to stabilize the nation's currency, keep unemployment low and prevent inflation.

Most central banks are governed by a board consisting of its member banks. The country's chief elected official appoints the director.

The national legislative body approves him or her. That keeps the central bank aligned with the nation's long-term policy goals. At the same time, it's free of political influence in its day-to-day operations. The Bank of England first established that model.

### Monetary Policy

Central banks affect economic growth by controlling the liquidity in the financial system. They have three monetary policy tools to achieve this goal.

First, they set a reserve requirement. That tells their network of private banks how much cash to have on hand each night. That controls how much banks can lend.

Second, they use open market operations to buy and sell securities from member banks. It changes the amount of cash on hand without changing the reserve requirement. They used this tool during the 2008 financial crisis. Banks bought government bonds and mortgage-backed securities to stabilize the banking system.

The Federal Reserve added \$4 trillion to its balance sheet with Quantitative Easing.

Third, they set targets on interest rates they charge their member banks. That guides rates for loans, mortgages, and bonds. Raising interest rates slows growth, preventing inflation. That's known as a contractionary monetary policy.

Lowering rates stimulates growth, preventing or shortening a recession. That's called expansionary monetary policy. The European Central Bank lowered rates so far that they became negative.

Monetary policy is tricky. It takes about six months for the effects to trickle through the economy. Banks can misread economic data as the Fed did in 2006. It thought the subprime mortgage meltdown would be restricted to housing. It waited to lower the Fed funds rate. By the time the Fed realized the slowdown was infiltrating the entire economy, it lowered the rate quickly. It was already too late.

But if central banks stimulate the economy too much, they can trigger inflation. Central banks avoid inflation like the plague. Ongoing inflation destroys any benefits of growth by raising prices, and costs, and eating up any profits. Therefore, central banks work hard to be sure to keep interest rates high enough to prevent it.

Politicians and sometimes the general public are suspicious of central banks. That's because they usually operate independently of elected officials. They often are unpopular in their attempt to heal the economy. For example, Federal Reserve Chairman Paul Volcker raised interest rates to curb runaway inflation. He was bitterly criticized for it. Central bank actions are often not well understood, which raises the level of suspicion.

### Bank Regulation

Central banks regulate their members by requiring enough reserves to cover potential loan losses. They are responsible for ensuring financial stability and protecting depositors' funds.

In 2010, the U.S. Congress gave more regulatory authority to the Federal Reserve with bank reform. The Consumer Financial Protection Agency gave regulators the power to split up large banks, so they don't become "too big to fail." It eliminates loopholes for hedge funds, and mortgage brokers. The Volcker Rule bans banks from owning hedge funds and using investors' money to purchase risky derivatives for their own profit.

It established the Financial Stability Oversight Council. It warns of risks that affect the entire financial industry. It can also recommend that the Federal Reserve regulate any non-bank financial firms. That's to keep insurance companies or hedge funds from becoming too big to fail.

### Provide Financial Services

Central banks serve as the bank for private banks and the nation's government. That means they process checks and lend money to their members.

They also store currency in their foreign exchange reserves. That allows them to affect exchange rates by adding foreign currency, usually the U.S. dollar or the euro, to keep its own currency in alignment. That's known as a peg, and it helps exporters keep their prices competitive.

Central banks also control inflation by managing exchange rates.

Most central banks produce regular economic statistics to guide fiscal policy decisions. Here are examples of reports provided by the Federal Reserve:

Beige Book: A monthly report from regional Federal Reserve banks on the state of the economy in their areas.

Monetary Policy Report: Semi-annual report on the economy

Credit Card Debt: A monthly report on consumer credit.