Edexcel (B) Economics A-level

Theme 4: Making Markets Work

4.5 Risk and the Financial Sector

4.5.3 The role of the central bank

Notes

The central bank manages the currency, money supply and interest rates in an economy. For example, the European Central Bank (ECB), the Bank of England and the People's Bank of China are central banks.

Implementation of monetary policy

The central bank takes action to influence the manipulation of interest rates, the supply of money and credit, and the exchange rate.

In the UK, the Monetary Policy Committee (MPC) alters interest rates to control the supply of money. They are independent from the government, and the nine members meet each month to discuss what the rate of interest should be. Interest rates are used to help meet the government target of price stability, since it alters the cost of borrowing and reward for saving.

The bank controls the **base rate,** which ultimately controls the interest rates across the economy.

Banker to the government

The central bank provides services to the Central Government. It collects payments to the governments and makes payments on behalf of the government. It maintains and operates deposit accounts of the government. The central bank also manages public debt and issues loans.

The Bank can also advise the government on finance, including the timing and terms of new loans.

Banker to the banks – lender of last resort

The Bank of England is considered to be a lender of last resort. If there is no other method to increase the supply of liquidity when it is low, the Bank of England will lend money to increase the supply.

If an institution is risky or is close to collapsing, the Bank might lend to them. This is when they have no other way to borrow money.

It can protect individuals who deposit funds in a bank and might otherwise lose them. It also aims to prevent a 'run on the bank', which is when consumers withdraw their bank deposits in a panic, because they believe the bank will fail.

Usually, banks will avoid borrowing from the lender of last resort, because it is suggests the bank is experiencing a financial disaster.

Role in regulation of the banking industry

Governments might regulate banks with regulation and guidelines. This helps to ensure the behaviour of banks is clear to institutions and individuals who conduct business with the bank.

Some economists argue that the banks have a huge influence in the economy; if they failed it would have huge consequences. Therefore, it is important to regulate the banking industry.

The UK banking industry is regulated by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The FCA regulates financial firms to ensure they are being honest to consumers and they seek to protect consumer interests. The FCA also aims to promote competition which is in the interests of consumers. The PRA promotes the safety and stability of banks, building societies, investment firms and credit unions, and ensures policyholders are protected.