



## The Power of Central Banks

**C**entral banks, such as the U.S. Federal Reserve, are arguably the most important and influential regulatory institutions in the financial and banking sector. They shape the environment in which banks operate, influence interest rates and the supply of credit, and often have an impact on the functioning of all financial transactions, including stock and bond markets. Changes in the financial sector can have immediate effects on the real economy – including the rate of unemployment, the real incomes of households, the [price level](#), and patterns of consumption and saving. Therefore, the way central banks make decisions influences the way economies, both domestic and global, really work.

What do central banks do? First and foremost, central banks help determine the regulatory environment in which private banks operate. As the “banker’s bank,” they can influence interest rates throughout the economy. Primarily they do this by influencing the levels of [reserves](#) – that is, money not yet committed as loans – in the banking system. When reserves increase, banks can lend more, the [money supply](#) expands, and [interest rates](#) fall. When free reserves decline, banks lend less, the money supply contracts, and interest rates climb.

Central banks also serve as a country’s lender of last resort. In a crisis, financial resources (sometimes referred to as [liquid assets](#)) are often needed to solve the problem. However, if no one is able to lend, the crisis can deepen. A key role of central banks is the commitment to supply credit during troubling times. In addition, central banks often enforce other regulations in the banking and other financial sectors (for example, [margin requirements](#) for [stock markets](#)).

Financial deregulation and the emergence of new forms of finance have meant that many banks and financial firms can dodge regulations much more easily. These developments have weakened the traditional role of central banks. These days, the primary channel through which the more influential central banks (for example, the U.S. Federal Reserve) affect financial markets is by altering the expectations of investors. A “positive” signal from the Fed can cause world markets to soar. In this respect, central banking is as much about psychology as it is about economics.

One critical policy debate concerns the independence of central banks. In this context, “independence” describes the relative distance between

the central bank and the political decision-making processes of government. The argument for greater independence is that, without a strong barrier between government and the central bank, monetary policies will be short-sighted and subject to political influence. In this version of reality, an independent central bank is an aloof observer of the economy, objectively making decisions for the long-run welfare of society.



However, the “independence” of central banks is often not what it seems. Often, private bankers, investors, and financiers have a good deal of influence over the priorities of a central bank. Therefore, an “independent” central bank is often removed from most forms of democratic accountability, but not from powerful influences. Policy choices often reflect this. As central banks become more independent, they tend to embrace low-inflation/high-interest rate strategies – exactly the types of policies that favor the financial sector. Likewise, lower rates of unemployment that could raise wages and lead to a

profit squeeze often cause central banks to take measures to slow down the economy.

Worldwide there has been a rapid movement towards more independent central banks at the same time that there has been a notable trend towards deregulation in the global financial system. For example, in preparation for monetary union, many of the central banks in the [Euro Zone](#) moved toward greater independence prior to the formation of the

European central bank. Less financial regulation around the world means that only the largest central banks will enjoy any kind of influence. And greater independence insures that the exercise of such influence will not be democratically accountable to the vast majority of the world’s population.

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