
Central banks and financial market regulation

Chapter 78 – April, 2017

CENTRAL BANKS

- ▶ Central banks:
 - ▶ Bank of England
 - ▶ Federal Reserve Bank
 - ▶ European Central bank
 - ▶ Bank of Japan
 - ▶ People's Bank of China
- ▶ Roles of a central bank:
 - ▶ issue notes and coins
 - ▶ implement monetary policy
 - ▶ manage exchange rates (i.e., buy/sell foreign currency or gold reserves)
 - ▶ banker to the government
 - ▶ *lender of last resort*
 - ▶ regulate the financial system
 - ▶ liaise with other central banks and international organisations (i.e., World Bank, IMF, ...)

ACTING AS BANKER TO THE GOVERNMENT

- ▶ Exception: ECB
- ▶ Exact functions may differ from country to country
- ▶ Central banks may
 - ▶ handle the accounts of government departments and
 - ▶ make short-term advances to government

ACTING AS BANKER TO OTHER BANKS

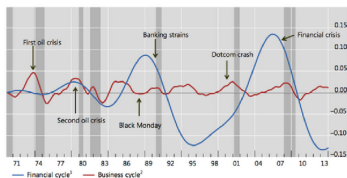
- ▶ Large banks have to *deposit* money with central banks
- ▶ These deposits are used to balance the accounts of banks at the end of each day
- ▶ *Lender of last resort* in case:
 - ▶ a bank at the end of a day's trading runs out of liquid assets to pay money it owes (short-term liquidity problem)
 - ▶ a bank faces fundamental problems because too many of its assets have fallen in value (prevents bank from collapsing)
- ▶ Does acting as *lender of last resort* result in *moral hazard*?
 - ▶ \ominus banks may engage in highly profitable, high-risk activities
 - ▶ \oplus if one bank fails, contagion will be avoided

REGULATOR OF THE FINANCIAL SYSTEM

- ▶ In *some* countries, central banks are regulating the financial system
- ▶ Financial regulation is needed for:
 - ▶ monitor financial institutions in order to avoid bad practices
 - ▶ avoid that these institutions engage in risky activities
 - ▶ avoid *systemic risk*: collapse of the whole financial system
- ▶ **Systemic risk index**

REGULATOR OF THE FINANCIAL SYSTEM

- ▶ regulation goes in cycles



¹ The financial cycle as measured by frequency-based (band-pass) filters capturing medium-term cycles in real credit, the credit-to-GDP ratio and real house prices.
² The business cycle as measured by a frequency-based (band-pass) filter capturing fluctuations in real GDP over a period from one to eight years.
Source: Drehmann et al (2012).

- ▶ *shadow banking*: non-bank financial intermediaries that provide services similar to traditional commercial banks but outside normal financial regulations (see [The Economist](#))

TYPES OF REGULATION

- ▶ issuing rules about how financial institutions should behave
- ▶ make sure that financial institutions have enough money reserves to cover any losses they make

TYPES OF REGULATION

2015	
Liabilities	
Customer deposits	£90
Shareholder capital	£10
Total liabilities	£100
Assets	
Mortgage loans	£100
Total assets	£100

2016	
Liabilities	
Customer deposits	£90
Shareholder capital	£2
Total liabilities	£92
Assets	
Mortgage loans	£92
Total assets	£92

2017 Insolvency	
Liabilities	
Customer deposits	£90
Shareholder capital	£0
Total liabilities	£90
Assets	
Mortgage loans	£89
Total assets	£89

TYPES OF REGULATION

2015	
Liabilities	
Customer deposits	£80
Shareholder capital	£20
Total liabilities	£100
Assets	
Mortgage loans	£100
Total assets	£100

2017	
Liabilities	
Customer deposits	£80
Shareholder capital	£9
Total liabilities	£89
Assets	
Mortgage loans	£89
Total assets	£89

KEYTERMS

- ▶ Central bank:
- ▶ Lender of last resort:
- ▶ shadow banking:
- ▶ systemic risk:

KEYTERMS

REVISION (CHAPTER 60)

- ▶ minimum wage: