Interest rates and central banks

1 Match the words in the box with the definitions below.

blue-chip companies	collateral	creditworthiness or credit rating
floating or variable interest rate	money supply	mortgage spread

1. A lender's estimation of a borrower's **solvency**, or their ability to pay interest and repay loans.
2. A loan to buy property or real estate.
3. Assets that secure or guarantee a loan, and that can be seized by the lender if the borrower does not repay.
4. Large businesses with a good reputation and a long record of being **profitable**.
5. One that changes (rises and falls) according to the **supply** and **demand** for money.
6. The difference between two prices (a buying price and a selling price).
7. The total amount of money in circulation in an economy.

2 Fill in the gaps using the words above.

In most countries the **central bank** fixes a **minimum interest rate**, called the **discount rate** [US], at which it makes secured loans to commercial banks. The lowest rate that commercial banks charge, to lend money to (1) __________, is called the **prime rate** [US]. The rate of interest borrowers pay depends on their (2) __________. Banks make a profit from the (3) __________ or differential between the interest rates they pay on deposits and those they charge on loans. Borrowers can usually get a lower interest rate if the loan is guaranteed by some sort of (4) __________. Consequently, a (5) __________ is much cheaper than a loan to buy a car or a boat.

Long-term interest rates are generally higher than **short-term** ones, except when the central bank temporarily reduces the (6) __________ and makes money or credit '**tight**' or **scarce**. Long-term loans like mortgages often have a (7) __________.

British English	American English
bank rate	prime rate
property	real estate

3 Complete the text using the words in the box.

balance	borrowing	cash	currency	inflation	invest	risk-taking	savers

Central banks generally act as banker to both the government and the commercial banks, issue banknotes, manage reserves of **foreign exchange** and gold, collect and publish monetary and banking statistics, and participate in the **clearing system** for settling inter-bank claims. But their main goal is probably to preserve the value of the (1) __________ – i.e. how much it will purchase, both at home and abroad.

Monetary policy is designed to achieve **financial stability** and to enable **non-inflationary** economic **growth**. Monetary policy operates mainly through influencing the price of money. In Britain, for example, the Bank of England is responsible for deciding the short-term level of interest rates necessary to meet an annual (2) __________ target set by the government.

Central banks generally implement their monetary policy through operations in the financial markets. There is often a shortage of cash or **liquidity** in the market each day, as the commercial banks have to maintain a minimum (3) __________ at the central bank. The central bank supplies the funds that the banking system as a whole needs to achieve balance by the end of each **settlement day**, and it can choose the interest rate at which it does this. This interest rate quickly affects the whole financial system, as the commercial banks change their own **prime rates** from which they calculate their deposit and lending rates for their (4) __________ and borrowers. This, in turn, affects spending, output, and employment, and eventually prices and costs.

Central banks try to set interest rates at a level which ensures that **demand** matches **supply**, or the **productive capacity** of the economy. If interest rates are set too low, this may encourage too much (5) __________ and spending by households and companies. If the demand for goods and services grows faster than the country's ability to supply items, prices will rise and inflation occur. If interest rates are set too high, individuals and households will borrow and spend less money, and companies will (6) __________ less in the future of the business. This will help bring down inflation but may also reduce **output** and increase the **unemployment** rate. Monetary policy is designed to maintain overall price stability. Some prices may go up, some may go down, but if the general price level of goods and services is unchanged, then money keeps its value. Stable prices help people to make well-informed decisions about whether to save or borrow, to invest or **consume**, and what and when to produce.

Central banks can also change the amount of money in circulation by changing the **reserve requirement** – how much of their assets commercial banks have to keep in (7) __________, and by selling short-term **government bonds** (such as 3-month **Treasury bills**) to commercial banks, or buying them back.

Supplying very short-term liquidity to commercial banks is described as acting as '**lender of last resort**' (LOLR). The central bank can also provide a 'safety net' by lending money to a failing financial institution, to enable payments and settlements, if the failure of one bank could spread through the financial system, **bankrupt** other institutions, and cause serious damage to the financial system and the wider economy. The danger of this is that the LOLR function might encourage excessive (8) __________ if banks believe that they are 'too big to fail' and will be rescued whenever they experience difficulties.

4 Find words or expressions in the text that mean the following.

1. Currency from other countries.
2. The amount of goods and services that consumers are willing to buy.
3. The condition of being out of work.
4. The increase of economic activity in a country.
5. The maximum amount of production possible.
6. The quantity of goods and services offered for sale by businesses.
7. The situation when something is not changing much.
8. The total quantity of all goods and services produced in an economy.
9. To drive an organization out of business because it can no longer pay its debts.
10. To spend money on goods and services.
11. When transactions have to be paid for.